Legal Structures depend on a Variety of Elements

To understand the legal aspects of factoring, we will first review today:
• Who the parties are to a factoring relationship, and factoring terminology
• Why client’s require factors
• How factoring developed historically;
• The wide variety of factoring products, and how they work; What distinguishes factoring from competing financial products, such as asset-based lending (ABL); and
• How factors manage their risks.

With this background, we will provide an overview of:
• Legal issues which arise between factors and their clients
• Legal issues which arise between factors and account debtors, and
• Legal issues which arise between factors and third parties (guarantors, tax authorities, other factors, etc.)

We will also discuss:
• What is needed, legally, to best facilitate factoring’s growth in Africa, and
• Points and issues to consider in structuring factoring laws in Africa, such as, for example:
  1. How broadly to define factoring - the sale of commercial/business accounts, alone? Something more?
  2. The extent, if any, to which a factor must assume “credit risk” in order for a sale of accounts to be treated as a “true sale” of accounts by the factor - Should full recourse factoring be treated as a purchase and sale of accounts as in many countries, such as the United Kingdom, and in Louisiana and Texas, in the U.S., for example, if that is the parties intent? Or, as in virtually all of the states of the United States, and in some foreign countries, does the factor have to assume credit risk for the transaction to be treated as a “true sale” under a factoring agreement?
Factoring – A Tri-partite Relationship

The Factor

Factoring Client

Goods/Services

Promise to pay

Sells Invoice

Payment

Account Debtor (customer)
Factoring (in the U.S.) defined

• The sale of accounts, at a discount, by the client to its factor
• Where the sale of the accounts is treated as a “true sale” of the accounts as a matter of law, from the client to the factor
• Meaning that legal title to the purchased accounts passes to the factor, from the client, and
• The accounts sold go “off balance sheet” on the Seller’s books and records

Note: Some might argue that this definition is too narrow
## Factoring Terminology

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
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<tbody>
<tr>
<td><strong>Accounts</strong></td>
<td>Monies owed, generally evidenced by an invoice or a purchase order, arising from goods sold and delivered</td>
</tr>
<tr>
<td><strong>Collateral</strong></td>
<td>As used in the Uniform Commercial Code, (the “U.C.C.”) refers to both (1) the Factor’s ownership interest in Purchased Accounts, as buyer thereof, and (2) the Factor’s interest, as lender, in Non-Purchased Accounts pledged by the Client to the Factor as collateral security for the Client’s obligations to the Factor under the Factoring Agreement</td>
</tr>
<tr>
<td><strong>Account Debtor/Customer</strong></td>
<td>The person to whom the Factor’s Client sold goods or delivered services</td>
</tr>
<tr>
<td><strong>Credit Risk</strong></td>
<td>The risk assumed by the Factor, on the terms of the Factoring Agreement, that a Purchased Account will not collect when due SOLELY because of Account Debtor’s bankruptcy or some other credit risk assumed by the Factor in the Factoring Agreement regarding the Account Debtor’s financial inability to pay</td>
</tr>
<tr>
<td><strong>Advance</strong></td>
<td>The payment made by the Factor to its Client (if any) on the date the Accounts are purchased. May be an interest bearing loan or a partial prepayment of the Factor’s purchase price, depending on the terms of the particular Factoring Agreement</td>
</tr>
<tr>
<td><strong>Discount Fees (aka Factoring Commissions)</strong></td>
<td>A fee charged for the Factor’s assumption of credit risk, and providing other services</td>
</tr>
<tr>
<td><strong>Batch (or Schedule)</strong></td>
<td>A listing of Accounts purchased by the Factor on any particular funding date or period</td>
</tr>
<tr>
<td><strong>Factor</strong></td>
<td>The purchaser of Accounts from the Client on the terms and conditions of the Factoring Agreement</td>
</tr>
<tr>
<td><strong>Chargeback</strong></td>
<td>A Purchased Accounts returned by the Factor to the Client, reversing the Factor’s purchase. Creates indebtedness owed to the Factor by the Client, satisfied by (i) debits to withheld Reserves, (ii) cash payments or (iii) substitution of new Eligible Accounts, without advances or payment thereon. Arises most often from disputed goods or services or from the tender of ineligible accounts.</td>
</tr>
<tr>
<td><strong>Funding Facility, aka Factoring Facility</strong></td>
<td>The factoring facility extended to the client pursuant to the Factoring Agreement and ancillary documents (financing statements, Validity (or full) guarantees, resolutions, etc.)</td>
</tr>
<tr>
<td><strong>Client</strong></td>
<td>The person who sells accounts to the Factor</td>
</tr>
<tr>
<td><strong>Non-Purchased Accounts</strong></td>
<td>Accounts not sold to the Factor in a true-sale; often pledged by the Client to the Factor in the Factoring Agreement as security for the Client’s obligations to the Factor</td>
</tr>
<tr>
<td><strong>Client Risk</strong></td>
<td>Accounts purchased for which the Client has risk of credit loss (as opposed to Factor Risk, where the Factor assumes credit risk)</td>
</tr>
<tr>
<td><strong>Purchased Accounts (aka Factored Accounts)</strong></td>
<td>Accounts sold by the Client to the Factor under the Factoring Agreement</td>
</tr>
<tr>
<td><strong>Credit Limit</strong></td>
<td>The maximum amount (in local currency) of Accounts owing by a particular Account Debtor for which the Factor assumes Credit Risk, set on a “credit line” or an order/shipment basis</td>
</tr>
<tr>
<td><strong>Reserve</strong></td>
<td>A bookkeeping account maintained by the Factor reflecting transactions between itself and the Client; in some sense, a “due to - due from” account on the Factor’s books. Cannot be charged with credit losses in nonrecourse factoring. Serves as security for debts arising from chargebacks, unpaid fees and costs, etc.</td>
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The roots of modern factoring in the practices of textile factors at Blackwell Hall, London, 1397-1800

Blackwell Hall was the center of the British textile trade. Blackwell Hall Factors:

• Were commissioned sales agents for their clients, textile makers in the North and West of England, accepting cloth on consignment, and selling to domestic and foreign merchants
• Provided financing to their clients by making cash advances prior to sale of the consigned inventory (e.g., 50% of the anticipated sales price) and, in some cases, a further advance post-sale, prior to collection (e.g., 20% of the sales price)
• Performed bookkeeping and collection services for their clients with respect to the accounts receivable arising from sales on credit (i.e., via promissory notes), disbursing the sales proceeds to the client upon collection, net of the factor’s fees, costs, and open advances.
• Provided marketing and general business advice to their clients (i.e., what sort of goods might sell best in the market), and
• Commencing in the 1700s, if not before, in consideration of a supplemental “del credere” commission, guaranteed to their clients the financial ability of the account debtors to pay (not necessarily that they would pay, just that they had the ability to pay. For example, if a customer had the financial ability to pay but chose not to, perhaps because of a dispute over the quality or quantity of the goods whose sale gave rise to the particular account receivable, this was not within the factor’s credit risk)
Factoring first came to America with the Pilgrims, in the 1620s.
Later, as American trade and commerce grew after the Civil War from 1860-1865, American textile mills (and other factoring clients) had less need for factors, often located in port cities, selling from a stock of consigned goods.
Rather, the mills now had their own sales departments and warehouses and could ship direct, by rail, and more readily contact the customer (telegraph, mail, etc.).
The McKinley Tariff of 1890 hurt American factors by imposing large tariffs on the import of European goods.

American factors, as a result of these pressures (1) dropped their sales agent roles and (2) began to operate as commercial financiers:

1. Credit-checking the client’s account debtors and buying accounts *without recourse*, to the extent of credit approvals/credit lines granted by the factor (assuming risk that a purchased account would not timely collect at maturity, due *solely* to the financial inability of the account debtor to pay thereon, to the extent stated in the factoring agreement (i.e., assuming “credit risk,” not “quality risk”);

2. In the “advance” form of factoring, providing client financing by “cashing the sale”; making cash advances to the client at 70-90% of the invoice price on the date the accounts were first purchased (and later, upon collection or deemed collection, making a “balance payment” to the client equal to the purchase price, less the factor’s fees, costs, and open advances);

3. Providing bookkeeping services, by ledging the purchased accounts and mailing the invoices to the account debtors, marked as having been sold and payable to the factor, and

4. Providing collection services, posting collections received (or deemed received), and disbursing the collected proceeds, net of the factor’s uncollected fees, costs and open advances.
The Modern Factor’s Principal Focus – on the Accounts

All commercial financiers, whether lenders or factors, focus on a variety of matters in underwriting a prospective relationship, including, among other things:

- The value and collectability of accounts offered for sale (or as loan collateral), including the strength and financial ability to pay of the underlying account debtors;
- The financial strength of the factoring client (or borrower);
- The extent to which the prospective client (or borrower) is leveraged, and
- The strength and integrity of client (or borrower) management.

Factors, as compared to banks and traditional lenders, place much more emphasis on the value and collectability of the accounts collateral.

Essentially, the factor looks to see if the accounts proposed for factoring are payable by credit-worthy account debtors, are valid, not subject to defense, offset, counterclaim, or a senior security interest, and billed and collected properly.
Why Clients factor their Accounts

As is evident from the factoring history just discussed, generally speaking, a client contracts with a factor to meet at least two of the following needs:

• **Credit protection**, to protect against the risk that an account owed to the client cannot be timely collected when due *solely* because of a bankruptcy or some other financial inability to pay of the account debtor obligated thereon;

• **Financing**, to accelerate the working capital cash cycle (often, for *new*, *fast-growing*, and *seasonal* businesses, as well as *companies in financial distress*, who cannot qualify for a traditional bank loan), by selling accounts and, in “advance factoring” transactions, obtaining a cash advance from the factor, generally 70-90% or so of the purchase price, at the time the accounts are sold. (In contrast, no factor advances are paid in either: (1) “collection factoring” transactions, where the factor pays when the purchased accounts collect (or are deemed collected) or (2) *maturity factoring*, where the factor pays on an agreed date, generally, the average due date of the accounts purchased in the particular batch, whether or not the factor has actually collected by that time or not);

• **Bookkeeping Services**, by, in effect, outsourcing the client’s accounts receivable/book-keeping department to the factor. Most times, the factor’s professionals can invoice and collect more effectively than the client can itself. The factor will ledger the purchased accounts. Historically, factors also invoiced the account debtors. Today, at least in America, some factors still send the invoices to the client; others merely take electronic assignment of the invoices and backup (purchase orders, bills of lading, etc.) and verify a sample of the information to see that the subject invoices have been marked to show their sale to the factor, etc.

• **Collection Services**, by the factor making collection calls, etc. In all forms of factoring, the factor pays the collected proceeds once received (or, in the case of nonrecourse factoring, deemed received, if credit risk assumed is triggered) over to the client, net of the factor’s fees, costs and open advances. Factor applies collections it receives on an account-by-account or a batch-by-batch basis, unlike a loan transaction.
Steps in a Typical (American) Factoring Transaction

Step 1 – Initial contact between the factor and the prospective client. Client submits an “Application” to the factor, often with a modest deposit. A non-binding letter of intent/proposal setting forth the principal terms of a possible factoring transaction, for discussion, only, is sent by the factor to the prospective client and signed by the prospective client.

Step 2 – Client delivers a schedule (list) of accounts which it wants to be factored, together with an accounts receivable aging thereof. The factor reviews (underwrites) the transaction by, among other things (1) calling/writing the account debtors who are obligated on accounts proposed to be factored to verify that they are valid and payable; (2) reviewing payment trends and history; (3) analyzing the prospective client (as the client must be able to satisfy charge-backs); (4) conducting UCC, tax, judgment and litigation searches on the client and its major account debtors; etc., and (5) setting credit limits, as to account debtors, and, in some cases, as to aggregate uncollected advances outstanding at any one time under the funding facility.

Step 3 – Legal Documentation is prepared. (Factoring and Security Agreement, Validity Guarantee(s), Client resolutions authorizing entry into the factoring agreement, IRS Form 8821, Tax Information Authorization, allowing the factor (or its agents) to access the client’s tax records at the Internal Revenue Service), preparation of a UCC-1 financing statement showing the Client as Debtor and the Factor as Secured Party or Buyer, listing the accounts purchased and any collateral being pledged to the factor, etc.

Step 4 – Closing and Initial Funding. Note: Even after a factoring agreement is executed and signed it is not uncommon for the factoring agreement to contain “conditions precedent” to the factor’s initial funding thereunder, such as, if not received prior to Closing, (1) proof that the various account debtors have all been notified that their accounts are being sold/assigned and are payable only to the factor, going forward; (2) factor’s receipt of estoppel letters from account debtors (or, at least, the larger ones) and landlords; (3) filing of UCC-1 financing statements (if not pre-filed); (4) receipt of executed guarantees from all Guarantors; (5) entry into pay-off letters or inter-creditor and subordination agreements with holders of security interests prior in time to that of the factor; (6) completion of integration of client’s accounting system with factor’s software and bookkeeping system; and (7) receipt of “bring-down” certificates, etc.

Step 5 – Closing batches of accounts; buying new accounts and later fundings, often weekly, going forward

Step 6 – Termination of the relationship (in the normal course, or upon default)
## How Factors Mitigate their risks

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<tr>
<th>FACTOR’S RISK</th>
<th>FACTOR’S MITIGATION</th>
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<tbody>
<tr>
<td>Client sells fake invoices</td>
<td>Factor (1) obtains client (seller) representations in the factoring agreement, that the accounts are valid and due and owing; (2) has charge-back rights against the client in these circumstances, for breach of seller’s warranties in the factoring agreement; (3) verifies the accounts, i.e., that they are valid, payable in full, etc., with the account debtors, pre-purchase and/or (4) obtains an “estoppel” letter from the account debtor, pre-purchase, promising to pay the account(s) without defense, offset or counterclaim. Under U.S. law, this gives the factor an independent cause of action against the account debtor.</td>
</tr>
<tr>
<td>Goods or services delivered by the factor’s client are faulty or defective</td>
<td>Same as above (the factor taking a representation, in the factoring agreement, that the accounts are payable without defense, offset, dispute or counterclaim; so right to chargeback disputed accounts.</td>
</tr>
<tr>
<td>Client diverts collections on purchased accounts</td>
<td>(1) factor notifies all account debtors on the particular accounts purchased that the accounts have been sold to and are payable only to the factor, coupled with (2) client’s agreement in the factoring agreement: (a) not to instruct account debtors to pay the client on purchased accounts; (b) turnover immediately to the factor any proceeds of purchased accounts inadvertently paid to the client, post-sale, plus (3) guarantees client will respect collection procedures</td>
</tr>
<tr>
<td>Account Debtors do not pay</td>
<td>If non-payment is due SOLELY to credit-risk assumed by the factor, this is the factor’s risk. Mitigation of the risk by (1) careful pre-purchase due diligence and setting credit limits; (2) definition of “eligible” accounts (avoiding, for example, excessive concentrations); (3) written notice to the account debtors of the factor’s purchase and instructions only to pay the factor, alone. Under U.S. law, this gives the factor a cause of action against the account debtor for “payment over notice”); (4) factor’s purchase of credit insurance or (5) re-factoring of accounts</td>
</tr>
<tr>
<td>A third-party (perhaps a bank, or another factor) claims senior rights in the purchased accounts</td>
<td>Under U.S. law, careful searching for competing security interests, pre-purchase, in the central UCC filing office of the seller’s place of incorporation, and filing of the factor’s own UCC-1 financing statements, to evidence the factor’s purchase of the accounts</td>
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</table>
Many Types of Factoring Agreements
(in the United States)

- **Non-recourse** (factor assumes credit risk, on agreed terms; 75% 2011 volume (CFA) vs. full recourse (no credit risk assumed; all accounts purchased at client risk; 21% of 2011 volume) vs. other forms (4% of volume) (partial non-recourse (factor’s assumed credit risk limited by time (for example, to 90 days post-invoice) vs. partial recourse (credit risk shared in agreed percentages, say, 80% factor and 20% client))

- **Notification** (account debtors told accounts have been purchased; 77% 2011 volume) vs. Non-notification (account debtors not told their accounts have been factored; factor’s client collects as agent of the factor, in consideration of an agreed fee, but factor provides credit protection and/or financing, via advances)

- **Advance factoring** (with client financing) vs. Maturity Factoring or Collection Factoring (no client advances in either case; client is purchasing principally credit risk protection from the factor, alone)

- Other forms of factoring:
  - Spot Factoring (factor buys one or a very few accounts)
  - Single Customer Credit-Approved Factoring (just one client account debtor, alone, is factored on a without recourse basis);
  - Split Factoring (either alphabetical or by line of business). For example, one factor buys accounts from client account debtors A, B, C, D and E while a second factor purchases all other client accounts. Factors have an inter-factor/inter-creditor agreement among themselves
  - Collection Services Factoring (f/k/a factoring by exception) – Rather than legal title to the factored accounts passing to the factor on the date of purchase, legal title transfers when the factor pays thereon.

Mixing and matching of the foregoing, depending on the parties needs and negotiating strength.
**Client’s choice of which form of factoring to use**

<table>
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<tr>
<th>Client’s Principal Need - To manage Credit Risk</th>
<th>Client’s Principal Need - For Financing (advances)</th>
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<tbody>
<tr>
<td>Maturity Factoring or Collection Factoring (no advances)</td>
<td>Advance Factoring</td>
</tr>
<tr>
<td>Nonrecourse factoring – factor accepts credit risk by purchasing accounts without recourse, meaning that, on the terms of the factoring agreement, the factor guarantees the account debtor’s financial ability to pay. Assumed credit risk can, by contract, be broad (the account debtor’s financial inability to pay) or narrow (limited, for example, to a legal insolvency, arising from bankruptcy or receivership of the account debtor, but not encompassing equitable insolvency, in the sense that the account debtor is unable to generally pay its debts when they become due, but is not bankrupt, yet)</td>
<td>Full recourse factoring – client refunds (via chargebacks) all purchased accounts which do not collect by an agreed date, often 90-120 days after invoice, even if the reason for failure to collect is a bankruptcy of the account debtor occurring post-purchase by the factor</td>
</tr>
<tr>
<td>A comparatively small number of factors provide this sort of traditional or “old-line” factoring</td>
<td>Both large traditional (old-line) American factors (21% of their 2011 volume) and hundreds of smaller factors provide full recourse factoring facilities</td>
</tr>
</tbody>
</table>
Client’s range of working capital options (extending beyond factoring)

- Advance Factoring
- Asset-Based Lending (ABL) (loans made to a borrower on the security of borrower-owned accounts receivable, inventory, etc.) or Invoice Discounting (“Factor” provides advances, generally on a full recourse basis, but not necessarily bookkeeping or collection services)
- Obtain Extended Supplier Credit (either voluntarily, by negotiating lengthier payment terms, or involuntarily, by the client holding payments due to the supplier longer);
- Sell accounts to an on-line platform (for example, in the United States, The Receivables Exchange (full recourse));
- Reverse Factoring (A large buyer, to get better terms from its suppliers, arranges for a factor to purchase supplier accounts owed by the buyer. This allows the account debtors to offer the buyer better trade terms, and pricing, because the extended payment terms so offered are now at the factor’s risk, not at the risk of the suppliers). Here, the account debtor arranges for the factoring, not the factor’s client as is customary.
## Factoring compared to Credit Insurance

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<tr>
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<th>Factoring</th>
<th>Credit Insurance</th>
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<tbody>
<tr>
<td><strong>Invoice Coverage</strong></td>
<td>100%</td>
<td>70-90%</td>
</tr>
<tr>
<td><strong>Period of Credit Guarantee</strong></td>
<td>Varies by form of factoring</td>
<td>Up to 180 days</td>
</tr>
<tr>
<td><strong>Turnover</strong></td>
<td>Choice of all accounts or those owing by individual account debtors</td>
<td>Normally, all accounts</td>
</tr>
<tr>
<td><strong>Collection Services</strong></td>
<td>Factor provides</td>
<td>Seller collects</td>
</tr>
<tr>
<td><strong>Client Financing</strong></td>
<td>Yes (without recourse)</td>
<td>Yes (with recourse)</td>
</tr>
<tr>
<td><strong>Deductibles</strong></td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>
No uniform legal standards in the U.S., or internationally, about what constitutes “factoring” and what creates a “true sale” of accounts

• There is presently no single uniform legal standard, either within the United States or internationally, across countries, about (1) whether and when a particular transaction constitutes “factoring” and (2) what does and does not create a true-sale of accounts

• At least in the U.S., “factoring,” in common commercial parlance (speech), includes any transaction which in “form” purports to be a purchase and sale of accounts, whether or not credit risk passes to the factor (as in “traditional” or “full service” factoring) or not
Traditional Factoring with a “true sale” of accounts, vs. Lending

A simple example illustrates very clearly the difference between “traditional” (aka “full service” or “old-line” factoring) on the one hand, where the factor buys accounts without recourse, and asset-based lending (where a lender makes loans which, while secured by accounts receivable pledged as collateral, are made on a full recourse basis), on the other hand.

Suppose Client Company sells a $1,000 account receivable owed by Customer A to the Factor, due in 60 days, at a flat 5% discount, with the Factor making an 80% advance on the date of purchase. Assume further that Factor buys the account “without recourse,” assuming, under the particular factoring agreement, the risk that the purchased account does not collect due solely to the financial inability to pay of Customer A. Factor also takes a “Validity Guarantee” from the principals of the Client. On the date of purchase, the Factor pays $800 to Client Company.

Had the transaction been an asset-based loan, at a 5% interest rate, the lender would, if it advanced 80% on the value of pledged accounts, have also paid $800 to Client Company. So, the same economics, so far (except that it is improper to equate discount fees with interest rates, because the factor’s discount fee compensates for services such as assumed credit risk, bookkeeping and collection that a traditional lender would not provide).

NOW, assume that 40 days post-purchase Customer A files for bankruptcy. NOW, the cash flows and the legal rights between the two transactions differ markedly:

Had the transaction been an asset-based loan, the Lender would, because it loaned on a full recourse basis, have (1) the right to sue Client Company (its borrower) immediately, for $800, the unpaid loan principal due and owing, without having to first try to collect the account owed from Customer A. So, the lender is “out” its $800 initial loan, NET of whatever the lender can collect from any other assets of Client Company (or, from any guarantors of the loan) and the interest charged on the loan.

In sharp contrast, if the ONLY reason the account did not collect was because of Customer A’s bankruptcy (and not because Customer A disputed the quality or quantity of the goods or services it received from Client Company), the Factor, because it purchased the account without recourse, not only loses its $800 initial “advance,” but the factor must now ALSO, the account being “deemed collected,” pay its client a “balance payment” equal to the Factor’s contractual purchase price ($950; i.e., $1,000 less a 5% discount fee of $50) less the Factor’s initial advance of $800, meaning the Factor pays its client a further $150. No asset-based lender would EVER go out of pocket for further money to its borrower in such circumstances. Nor can the Factor recover from the Validity Guarantor because a validity guarantee is only a guarantee that the account is valid and complies with the seller’s representations and warranties, and does not extend to assumed credit risk. Therefore, the Factor loses $950, less whatever the Factor can recover on its claim in the bankruptcy of Customer A and the discount fee. AND, if the factor cannot recover in the bankruptcy (or recovers only partially), the Factor cannot sue Client Company for any short-fall. (As noted above, a lender could seek a deficiency judgment).
Full Recourse Factoring vs. Lending

• When a factor buys accounts with full recourse, the “economics” of a factoring transaction, on the one hand, and a lending transaction, on the other hand, are rather similar. The full recourse factor does, however, often provide bookkeeping and collection services to its client that a traditional lender does not.

• In the United States, in 48/50 states, most courts would re-characterize a full recourse factoring transaction as being a secured loan at law, ignoring the “form” of the “purchase and sale of accounts” in the factoring agreement. However, some U.S. courts, such as the Ninth Circuit Court of Appeals and the Arkansas Supreme Court, have respected “full recourse” factoring transactions as “true sales,” based on (1) the express intent of the parties, in the factoring agreement, to accomplish a purchase and sale of accounts and (2) the client’s inability to re-purchase accounts from the factor at will. While the factor has a right to charge-back accounts that do not timely collect, a “put,” as it were, the client cannot “call” (repurchase) the accounts from the factor over the factor’s objection.

• In the United Kingdom, and in many other countries, courts treat a full recourse factoring transaction as a “true sale” of accounts by the client to the factor because, in their view, the intent of the parties, not economics, governs the legal form of the transaction. See e.g. Hallmark Cards, Inc. v. Yun Choy Ltd., 5 H.K.C. 453 (C.F.I. June 16, 2011) (a decision of the Court of First Instance in Hong Kong, following English precedents)
Why the definition of “factoring” matters (under U.S. law)

- In many U.S. states, there is a limit on the level of interest that can be charged on both (a) personal loans and (b) business loans.
- For example, under New York law a business loan carrying interest of more than 25% is criminally usurious and may not be able to be collected, in whole or in part.
- Compare Virginia law, where there is no interest limits on commercial loans.
- Generally speaking, all U.S. states, in one form or another cap the interest that may be charged on non-business (consumer) loans.
- A full recourse factoring transaction in the United States is more likely to run afoul of these “usury” laws.
Is there a need for model factoring laws in Africa?

- In the United States, factoring is, at present: (1) totally unregulated at the federal level and (2) only regulated, to a modest degree, in a minority of states (the California Finance Lenders Law, for example);
- In Europe, my sense is that legal requirements exist for factors to operate in some, but not all jurisdictions (for example, minimum capital levels, licensing, etc.)
- In both the U.S. and England, there are specific locations where a factor considering a transaction can search for both (1) competing, existing liens and security interests, pre-purchase, and (2) post-purchase, for new liens and security interests which could “prime” or “impair” the factor’s position (such as later filed tax liens that take priority or liens/security interests of a junior factor or lender, taken in violation of a “no further encumbrances” clause in the factoring agreement.)
  - In the U.S., the U.C.C. tells the factor to search for competing liens/security interests of a “registered organization” (i.e., a corporation, limited partnership or limited liability company)
  - In the U.K., security interests/pledges are filed at Companies House, and Bills of Sale at the Royal Court of Justice, in London
- There is little need for model factoring laws in the U.S. and the U.K. because in both jurisdictions factoring and its business practices are relatively well-known and we have many, many years of judicial “case law,” especially in the U.S. (Modern factoring was only returned to the U.K. from the U.S. about 1960, having died out in England some time in the 1800s). As well as, in the United States, a comprehensive “Uniform Commercial Code,” hundreds of pages long, which provides significant guidance. The U.C.C. is in force (albeit, with some variations) across all 50 states.
- In Africa, there is a much greater need for model laws, as (1) factoring is relatively unknown; (2) commercial laws are (relatively) less established, (3) there is often no central registry of security interests, etc.
Examples of Legal issues/disputes between factors and their clients under U.S. factoring law

BY THE FACTOR, AGAINST THE CLIENT
1. Breach of contract (violations of seller representations and warranties)
2. Account stated (client’s failure to timely object to factor’s statement of account)
3. Attorney’s Fee claims
4. Tort claims (conversion/theft of collateral, fraud or negligent misrepresentation, fraudulent conveyance)

BY THE CLIENT, AGAINST THE FACTOR
1. Breach of contract (failure to fund, improper chargebacks, payment not credited, alleged modifications to the factoring agreement, orally or by conduct
2. Suit beyond the statute of limitations
3. Tort claims (Factor’s violation of good faith and fair dealing, fraudulent inducement and negligent misrepresentation, truth-in-lending, usury)
4. Procedural (lack of jurisdiction, improper venue or forum, etc.)
Representative Legal Issues/disputes between factors and account debtors under U.S. factoring law

BY FACTOR AGAINST THE ACCOUNT DEBTOR
1. Breach of contract
2. Estoppel, created by the account debtor’s verification of the account
3. Improper payment by the account debtor to the client after notice the subject accounts were sold to the factor

DEFENSES OF THE ACCOUNT DEBTOR
1. Breach of contract (dispute over quality or quantity of the goods received)
2. Set-off
3. Recoupment (essentially, a set-off arising from the “same transaction”)
4. Lack of consideration for the account debtor’s verification given to the factor
5. Lack of authority by the person signing a verification or an estoppel letter
6. Statute of limitations, arbitration clauses, lack of jurisdiction
7. Bankruptcy of the account debtor
Legal issues/disputes between factors and other third parties

OTHER LITIGATION BETWEEN FACTORS AND THIRD PARTIES

• Guarantors
• Tax Authorities
• Other factors or lenders claiming priority
• The factor’s own lender
• The factor’s Re-factor
• Effects of a bankruptcy filing by either the factor’s own client or by an account debtor
What is needed to make factoring the best it can be, in Africa

• Good model laws (covering the rights of factor’s, their clients, account debtors, guarantors, etc.)

• Sound education on what factoring is (and is not), and how it differs from other financial products

• A well functioning legal system, not subject to corruption

• A central registry where liens and security interests can be registered and easily located, including electronically
Possible Questions for African legislators and regulators to consider

1. What should the definition of “factoring” be?
   • Does it require that the factor assume credit risk, as under U.S. law? If so, how much credit risk must the factor assume? Because asset-based lenders assume no credit risk at all, is any assumption of credit risk sufficient to create a true sale?
   • Or should the intent of the parties govern, as in U.K. law?
   • The IFG Model Factoring Law, and the various other model acts (UNIDROIT, UNCITRAL) all follow the U.K. approach. See Sections 1.2 of the IFG Model Law.

2. Should factoring be limited to just accounts owed by commercial/business account debtors, consistent with factoring’s history and early model laws (UNIDROIT, 1988)?

3. Can personal debts (such as, for example, credit card receivables) be purchased and sold under factoring law, as long as the buyer is a commercial person?
Possible Questions for African legislators and regulators to consider (cont’d)

4. What carve-outs should exist from the scope of factoring law (perhaps, as an example (i) accounts arising from the sale of a business and (ii) accounts on which the account debtor is an individual, arising from the account debtor’s purchase of goods for personal, family or household use)?

5. Must factoring agreements be written or are oral factoring agreements enforceable?

Note: In the United States, oral factoring agreements can be enforced as that was the common law. Therefore, a factor’s letter of intent/proposal, signed by the prospective client, will be clear, like the factoring agreement itself, that under no circumstances will be factor be bound orally
Possible Questions for African legislators and regulators to consider (cont’d)

6. For factoring to be legally enforceable, does the factor’s security interest have to be registered at a central location? Or, is it enough that the factor notifies the account debtor obligated on the account that its account has been purchased, and to pay the factor? What rules govern if the account debtor receives competing notices? (American rule, first person to take assignment of accounts from the client wins; English rule, first person to notify the account debtor wins)

7. Will non-notification factoring be accepted, so long as the client commits, in the factoring agreement, to serve as the factor’s collection agent? Or, must all factoring be done on a “notification” basis

8. Can a factoring client agree in advance to automatically sell to the factor all future accounts as they arise from the delivery of goods and services, subject to whatever credit limits are established by the factor in the factoring agreement?

9. Will electronic signatures be recognized?

10. What laws should govern the exchange of electronic data in factoring deals?
Possible Questions for African legislators and regulators to consider (cont’d)

11. Does a factor buy accounts subject to third-party rights (e.g., an arbitration clause in the underlying purchase order between the factor’s client and the account debtor)?

12. If the underlying contract between the factor’s client and the account debtor prohibits the client from selling or assigning the account, should factoring law over-ride that limitation (as in the United States)?

13. Does the factor’s security interest/lien have to be legally registered at a certain location, as in the United States and the U.K., to be legally effective? Where?

14. If the transaction is treated as a “true sale” of accounts under the factoring laws of the particular African country, does this mean that the factor’s interest in the purchased accounts is not “property of the bankruptcy estate” if the factor’s client becomes bankrupt, so that the factor can direct collect on the accounts, without court approval, even after the bankruptcy (as in the United States)?