Afreximbank Conference - Lusaka

Regulatory and Legal Aspects of Factoring

&

International Factors Group Model Law of Factoring
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Voted the top firm for asset based lending by Business Money 2011, 2012 & 2013

Rated top tier firm for asset based lending by UK’s Legal 500 guide

44 offices in 21 countries - Legal counsel world wide
Three Topics

1) Regulation of Factoring Companies

2) Laws Affecting Conduct of Factoring

3) IFG’s Model Law for Factoring Relationships - 2014
Regulation & Compliance

- Best source of information – European Union of Factoring Associations
- “Comparative Study of Legal Environments”
  - From http://euf.eu.com/what-is-euf/objectives/euf-legal-study.html
  - Cost eur 100 plus postage

- Covers:
  - all 27 EU countries
  - Plus USA, Norway, Russia, Turkey & Switzerland

- Other countries at IFG website (www.ifgroup.com)
  - Including China, Australia, Hong Kong, India, Japan & Brazil
Regulation - definition

Rules or directives made and enforced by a higher authority in order to control and govern the conduct and behaviour of another organisation
Positive & Negative Aspects of Regulation

- **Positive**
  - Sets minimum standards
  - Controls behaviour
  - Transparency
  - Gives clients confidence in factor and its products
  - Increases good reputation of the factoring industry

- **Negative**
  - Regulator’s bureaucracy ultimately paid for by factor and client through license fees
  - Factor’s overheads increased – diverting people & resources in compliance activities
  - Regulator not understanding factoring
  - General rules not adaptable to factoring
  - Reduces competition
Topics Covered by Regulation

1. Authorisation of factoring companies

2. Specific laws covering assignments

3. Value added taxes on:
   1. Assignment of debts
   2. Service charges
   3. Interest or discount charges

4. Penalties for late payment of debts

5 International conventions in force
Degrees of Regulation

1) Complete government supervision, regulation and licensing of all products and services – China

2) Full banking licence issued by national central bank and compliance with Basel II – France

3) Registration as a “financial institution”
   - unable to take deposits and lesser capital requirements – many European countries

4) No official regulation or supervision at all – UK – But
   - Self regulation, complaints procedure and compensation by national factoring association in UK through Asset Based Finance Association

4) Membership of two factor organisation such as FCI or IFG
   - setting standards for business between members and arbitration of members’ disputes.
Factoring operates successfully in all 33 surveyed countries.

NB It operates in approx. half the countries without any need for authorisations or supervision, including:
- UK, Czech Republic, Netherlands, Poland, Latvia, Slovakia, Switzerland, Luxembourg.

USA has no Federal Government supervision but states have varying degrees of supervision.

Offering credit insurance almost always need an insurance company licence. Non-recourse not always treated as insurance.

Full banking licence with compliance with Basel rules - France
Other Regulations

- Other authorisations which factoring company may need
  - Anti money laundering registration and compliance (UK)
  - Data protection registration and compliance (UK)
Specific Laws & Practices for Assignments

- Are there specific laws on how assignments are made?

- To be effective, must assignments be:
  - Written?
  - Notified to debtor?

- Can future debts be assigned?

- Can debts be assigned electronically?

- Are electronic signatures legally valid?

- Are prohibitions on assignment effective?

- Does client’s insolvency affect a factor’s rights?
Specific Laws on Assignments

- Specific laws on how assignments made in 95% of countries

- Assignment must be written in 80%
  - In practice 100% are written – to avoid disputes.
    - In UK verbal assignments possible - never used commercially

- Debtor to be notified for a valid assignment in 85%
  - Not needed in UK, USA & Denmark

- Assignment of future debts possible in 80%

- Electronic assignments valid in 87%
Issues Affecting Assignments

- Debtor’s Contractual Prohibitions on Assignment
  - Effect varies between:
    - Being treated as totally ineffective – Hungary & Italy
    - Making the debt impossible to factor – Spain

- Problems avoided by:
  - Having factor collecting under a power of attorney
  - Directing payment to bank account in client’s name but operated by factor (England)

- Need for public registration of assignments
  - Not generally needed except Netherlands, Romania, Norway, Australia, New Zealand & Canada
  - In England future assignments must be publicly registered for unlimited partnerships and sole traders
  - In England registration of future assignments by companies being considered.
Issues Affecting Debts

- Payment methods
  - In 65% of countries inter bank transfers are most common method
  - Cheques preferred in Cyprus & Malta

- Late payment penalties are usual
  - By debtor / client contract
  - By general law.

- Effect of client’s insolvency
  - Only in 40% of countries does the factor have priority over general creditors.
  - Deep reservation of title (by supplier of unpaid goods to client) can attach to goods onward sold and thus make factor’s debt uncollectable (not surveyed but problem in UK)
Taxes

- Generally there is no tax on the assignment of debts
  - Except Austria, Romania & Norway

- Value Added Treatment (“VAT”)
  - Almost all countries charge VAT on the service/administration charge
    - except in Finland and Portugal
  - Interest /discount charge is not subject to VAT
    - except in Greece, Latvia, Romania, Russia, Cyprus & Turkey
Threats and opportunities for Factors

- **Problems to overcome**
  - Negative reputation of factoring – seen as financing of “last resort”
    - Publish lots of success case studies
  - Legislative/compliance authorities often do not understand factoring
    - Expose them to your best public relations
  - Compliance standards are often not suitable or not specially adapted for factoring
    - Offer to help redrafting after identifying evils to be overcome

- **Opportunities**
  - Factoring has high growth potential
  - A modern product which has shown itself capable of adapting to all existing legal and regulatory environment
The Perfect Environment?

- No authorisation or regulation needed – serves no useful purpose merely increases costs

- Written assignments of debts needed – for certainty

- Electronic assignments valid – quicker availability of funding

- Assignment of future debts by factoring agreement possible

- Assignments to be valid without notice to debtor - encourages confidential invoice discounting

- Deep reservation of title (by client’s supplier) to the proceeds of sale to be ineffective – if prior public registration of factoring facility
The Perfect Environment?

- Public registration or notice of factoring agreements
  - to prevent fraud of double assignments
  - to obtain priority over subsequent secured creditors such as banks with debentures
  - to put other creditors on notice and obtain priority in insolvency

- Prohibitions against assignments by debtors to be invalid - as they discourage access to finance

- Factors to have priority over general creditors, upon client’s insolvency provided factoring agreement registered – to encourage funding of “turn-around” situations.

- Late payment penalties established by law – to encourage prompt payments
The Route to a Model Law

The International Conventions on Factoring

- Unidroit – Convention on International Factoring - Ottawa 1988
Unidroit Convention on International Factoring - 1988

Now law in France, Belgium, Germany, Hungary, Latvia, Nigeria & Ukraine

Used as basis for modernising law in Lithuania & Russia
Unidroit International Factoring Convention

- **Applies**
  - to debts where supplier (client) and debtor are in different states; and
  - convention is law in states of client, debtor and factor; and
  - supply contract governed by law of a contracting state; and
  - Factor provides at least two of these services:
    - Finance; or
    - Ledger accounting; or
    - collections; or
    - bad debt protection
  - Notice of assignment given to debtor so limited to notified factoring
  - Notice must be given by client

- **Nothing innovative but:**
  - Rights and duties of parties set out
  - Prohibitions against assignments are ineffective against factor
  - Advance payments by debtor to factor recoverable in certain circumstances
States do not have to pass entire convention into law – Belgium has opted out of prohibition on assignment aspects

Contracting parties can exclude whole of convention from their relationship - but not parts.
UN Convention on Assignment of Receivables in International Trade Law - 2001

- Covers wider receivables products than Unidroit, including forfaiting, securitisation and factoring in all forms, notified and confidential

- No country has passed it into law

- Basis of IFG’s “Model Factoring Law”
IFG’s Factoring Model Law - 2014

- Purpose – to provide legislators with a draft law in line with internationally accepted and developed legal principles

- Framework easily adaptable to specific legal environments

- Although based on UNCITRAL it is limited to factoring (in all variations) based upon assignments so it excludes secured transactions.

- Covers domestic and cross border assignments

- Covers domestic and international receivables

- Parties can opt out by agreement from any aspect (compare with Unidroit’s all or nothing)
Specific Provisions of IFG’s Model Law

- Factor need only provide *one* service from:
  - Finance
  - Ledgering
  - Collection
  - Bad debt protection
  - (compare Unidroit’s need for two)

- Receivables covered:
  - present and future receivables
  - from credit card transactions

- Receivables not covered:
  1) from financial services
  2) from construction contracts
IFG’s Model Law

- Receivables not covered
  3) from sale or lease of land
  4) from sale, license or lease of intellectual property

- Transferred with receivable
  - All rights to obtain payment including guarantees

- Client is treated as representing that:
  - It has right to assign
  - Debt not previously assigned
  - Debtor has and will not have any defences or set-offs

- NB there is no representation by client that debtor can pay.
  - so without further variation this would be a non-recourse assignment with bad debt protection.
Prohibitions on assignment do not affect validity of assignment
- But client liable in damages to the debtor for breach of contract
- Such damages cannot be claimed or set-off against factor.

Notices of Assignment
- Effective upon receipt (an issue not covered by UNIDROIT)
- Can be in language of supply contract
- Can cover future debts
- Once notice given - payment or returned goods can only be to the factor
- Does not affect the debtor’s rights
- Can be given by factor (improvement on UNIDROIT)

Factor’s payment instructions
- Must be complied with
- Cannot change payment currency
- Cannot change state where payment must be made
IFG’s Model Law

- **Factor entitled to proceeds paid to client**

- **After receipt of notice of assignment**
  - debtor can request proof of assignment
  - if proof not provided debtor can pay client.
  - debtor and client cannot change contract of sale

- **Debtor’s valid defences and set-off against the factor:**
  - All those arising from supply contract
  - All those arising from any other contract which is part of the same transaction
  - Any others on any grounds that could be raised at time of notice of assignment

  *but not damages for breach of any prohibition against assignment.*

- **Debtor can agree in advance with the factor not to raise defences or set-offs against the factor.**
IFG Model Law - Priorities

- IFG Model Law envisages national laws introducing a priority system based upon public registration of factoring and security agreements.

- Awaiting model laws from UN discussions

- Registration already exists in Canada, Australia and New Zealand

- UK discussing registration

- Rome I Convention has not yet solved third party priority rights for EU, so a priority law based upon public registration via internet would be useful
Model Law & Regulation - Conclusions

- Factoring often starts in a country without a specific factoring law
  - But existing laws can usually be applied or interpreted
  - In common-law countries (UK, USA, Australia, New Zealand) case precedent law can build up a body of judge made law but sometimes difficult to locate or draw conclusions

- Absence of a specific factoring law results in uncertainty
  - UK still has to define “factoring”
  - UK rights and obligations under general law between the factor and client are often unclear – hence need for long factoring agreements

- Adopting a model law into local legislation will enhance the profile of factoring, instil public confidence, promote sound financing and trade.

- Whether to impose or increase regulation on local factoring operations must be a matter of further debate.

- UK experience in an unregulated environment has allowed growth averaging 20% a year for decades
  - but ownership of many factoring companies by regulated banks may have helped public perception.
For Debate

➢ **Do we want to encourage or increase Regulation of our industry?**
  Yes or No?

➢ **If yes – decide extent of regulation. E.g.**
  ➢ products
  ➢ fees
  ➢ capital requirements
  ➢ Reporting to regulators
  ➢ ombudsman & compensation of clients
  ➢ fit persons in charge
  ➢ shareholders
  ➢ other topics

➢ **How to educate regulators**

➢ **How to make public aware of benefits of being regulated**
For debate

- Do we need or want a specific law for factoring
  Yes / No?

- If yes, then what changes (if any) do we make to IFG’s Model Law?

- How to influence opinion formers

- How to approach legislators?

- How to promote an appreciative business climate to factoring?
Wishing you every success in your discussions

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