CHAPTER - 8
LEGAL ISSUES IN INTERNATIONAL FACTORING

8.1 Introduction

As stated in chapter 2, there are still many undecided areas in respect of laws relating to international factoring though a substantive attempt was made in Unidroit Convention to bring about harmonisation in rules relating to such transactions. The unfortunate situation is that in no country of the world, there is any comprehensive legal framework even for domestic factoring.\(^1\) In USA, however, the Uniform Commercial Code (UCC) contains certain provisions that deal with factoring and financing of trade debts (referred to as ‘account receivables’ in US).\(^2\) Similarly, in Italy, which has one of the largest factoring businesses in the world, some efforts are being made to enact comprehensive legal framework for smooth factoring operations.\(^3\)

However, legal issues relating to factoring arrangements in cross-border transactions are fraught with many more uncertainties as complications often arise as to

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\(^1\) Report of Factors Chain International, 1989, Amsterdam, the Netherlands.


\(^3\) ibid.
which national laws are to be applied for solving disputes between different parties located in two different countries. Therefore, the legal intricacies involve broadly two facets - (i) Domestic legal framework and (ii) International applicability.

8.2 Present Legal Position

In India, like many other countries of the world, there is no proper legal framework to support factoring transactions. Under such a situation, therefore, factoring activities, like many other modes of financing have to operate within the existing laws relating to

- Indian Contract Act, 1932
- Indian Sale of Goods Act, 1930
- Transfer of Property Act, 1881 etc.

In the absence of a proper legal framework, even definition of factoring and the type of legal relationship arising therefrom remain uncertain. The question arises - can factoring be treated as lending against security as is the case with advance against book debts or bills financing? Or does factoring constitute outright sale of trade debts passing on the title to receivables arising from the credit sale of the goods/services from the supplier to the factor? Legal framework should also clearly define and distinguish the rights, duties and obligations of the various parties involved in a factoring transaction besides stating unambiguously the countervailing rights of the debtors. The conflict of interest between the factor and other assignees as well as other claimants to debts has to
be resolved. These claimants include the unpaid suppliers of the exporter and also the receiver(s) in case of insolvency of the exporter.

8.3 Need for Comprehensive Legal Framework

In view of the prevailing situation, the experts are of the opinion that a comprehensive legal framework should be enacted to define the term factoring and establish the rights, duties and obligations of various parties involved in such transactions. However, there is another viewpoint as well. In a country like India, it may take a long time to enact a full-fledged legal framework. Therefore, let the operations start within the given situation wherein sufficient, though not full, clarity exists and depending on the response and decided cases, legal issues will themselves get crystallized. To support this point, it is argued that no legal framework exists even for hypothecation or leasing finance. Similarly, for hire purchase activities, the Hire Purchase Act, 1972 which was enacted earlier stands withdrawn. But all these activities continue to be carried on without much of difficulty from the legal viewpoint.

8.4 Assignment of Debt

In international trade transactions, the issues get further complicated owing to what is known as Conflict of Laws applicable to various countries. While it is beyond doubt that the validity of contract between a supplier (exporter) and the export factor is to be governed by the factoring agreement drawn under the legal framework of the country of the exporter, the grey area is regarding validity of assignment as against the debtor
(importer). The validity of assignment against the debtor herein referred to arises from the sub-assignment by the export factor of his rights to his correspondent, that is the import factor. Since the two factors are located in different countries, the question arises as to which country’s laws shall be applicable in respect of such assignment. Even the Unidroit Convention is silent in this regard. This issue is of paramount importance towards protection of the export factor’s security which primarily depends on his right to get payments from debtors abroad. The export factor in India by virtue of the covenant in factoring agreement may insist that the transaction shall be governed by Indian Law; nevertheless this may be negated by the courts of law of the other country. It was at one time thought that a debt (being intangible) had no locality but courts have now evolved rules for determining the situation of the intangibles.\(^4\) It is now argued that a contract debt must be situated in the country where the debtor has his place of business for that is where it may normally be enforced.\(^5\) But this is the general rule only and it may in certain circumstances be negated by the terms of the contract out of which the debt arises and if the debt is not yet due for payment, it may have no locality because it cannot then be enforced.\(^6\)


\(^6\) ibid, p 909.
The above discussions tend to convince that the assignment should be valid from the legal viewpoint of the countries of both the exporter as well as the importer. The conflicting laws of the two countries may pose a difficult proposition in certain circumstances. For instance, the provisions of Section 130 of Transfer of Property Act, 1881 which deals with the transfer of actionable claims (including assignments) read as under:

"The transfer of an actionable claim whether with or without consideration shall be effected only by execution of an instrument in writing signed by the transferor or his duly authorised agent, and shall be complete and effectual upon the execution of such instrument and thereupon all the rights and remedies of the transferor, whether by way of damages or otherwise, shall vest in the transferee whether such notice of transfer as is hereinafter provided, be given or not. Provided that every dealing with debt or other actionable claim by the debtor or other person from or against whom the transferor would, but for such instrument of transfer, as aforesaid, have been entitled to recover or enforce such debt or other actionable claim, shall (save where the debtor or other person is a party to the transfer or has received express notice thereof as hereinafter provided), be valid against such transfer.

The transferee of an actionable claim may, upon the execution of such instrument of transfer, as aforesaid, sue or institute proceedings for the same in his own name without
obtaining the transferor’s consent to such suit or proceedings and without making him a party thereto."

Thus, in brief, the characteristics of the process of assignment of actionable claim (trade-debts) are as follows:

(i) It must be in writing.

(ii) It should be signed by the transferor or his duly authorised agent.

(iii) Notice to a debtor is not necessary to complete the assignment.

(iv) Unless and until the debtor is a party to such transfer, he gets a valid discharge by making payment to the assigner.

(v) After assignment, the rights and remedies of the transferor vest in the transferee.

This implies that notice to debtors is not necessary to complete the process of assignment in respect of factored debts as far as the legalities of Indian context are concerned. On the contrary, as per stipulations contained in Article 1 (2) (c) of the Unidroit Convention, to complete the process of assignment notice thereof is to be given to the debtors. Therefore, in respect of factoring contracts entered between an Indian exporter and export factor towards the goods supplied by the former to a debtor located in a different country, notice of assignment must be given. Simultaneously, the assignment must be got validated according to the legal provisions of the debtor’s country.
This calls for intimate knowledge on the part of the export factor towards the various legal framework of the debtor's country. This is the reason why the Two Factor System as discussed in chapter 2 has gained acceptance in practice as the import factor being located in the debtor's country would be in a better position to complete the process of valid assignment in that country.

8.5 Insolvency of the Client

The other major area of concern is the resultant dispute regarding enforceability of debts by the factor in case of insolvency of the exporter. The export factor may be under the impression that his right to receive payment in eventuality of insolvency of his exporter client might be governed by legal provisions of exporter's country. But in reality it may not happen; the legal provisions of the debtor's country may vitiate the process of his right of recovery. The example of the above cited argument is the famous Tay Valley Case (Tay Valley Joinery Ltd V.C.F. Financial Services Ltd, 1987, S.L.T. 207) in England. In that case, counsels for all parties agreed that the question should be governed by the Scots Law, because most of the debtors of the insolvent client were Scottish, notwithstanding that the factoring agreement provided that it should be governed by English Law.\(^7\)

8.6 Stamp Duty Considerations

According to Indian Stamp Act, duty is payable on an instrument and not on transaction. However, the instrument executed denotes a specific transaction. The master factoring agreement, the main instrument in factoring operations is a conveyance or transfer of property and is, therefore, liable under the Act for payment of duty. This is the legal position. However, if this is viewed vis-a-vis the facilities of bills finance and hypothecation against book debts, the proposition may work out to be costly and unattractive to the prospective exporters.

To overcome the problem, various suggestions that were offered are as under:

(i) In order to make the experiment a success, factoring transaction should, by statute, be exempted from stamp duty payments.

(ii) If for any reason, the aforesaid proposition is not found feasible, at least a beginning can be made by exempting the invoices assigned upto a specific amount, say Rs. 50,000 per transaction. For instance, in UK exemption is allowed to independent transaction(s), whereof the consideration does not exceed £ 30,000.\(^{2}\)

(iii) If the basic legal relationship between the supplier and the factor is changed to the ‘debtor’ and ‘creditor’ from that of the ‘assigner’ and

\(^{2}\) ibid, p 53.
'assignee', the stamp duty can be avoided. The transaction will then, however, become akin to the one existing between the borrower and the banker, as in case of any other type of advance, which may be against the very spirit and tenant of factoring.

(iv) If the factoring agreement is executed on "facultative" basis (discussed below), the offer document itself does not evidence assignment and hence, stamp duty need not be levied on such an instrument.

However, in respect of international factoring, the issue relating to the sub-assignment created in favour of the import factor by his export counterpart depends on the related provisions of importing country, though Unidroit Convention is silent on this issue. For instance, for a factoring transaction between an Indian exporter and an importer in UK, as per the Law of Stamp Duties in the latter, the documents become liable for stamping as soon as they arrive there and they must be stamped within 30 days of their arrival. Therefore, the consideration regarding payment of stamp duty on the assigned debts in an international trade transaction owes to the legal conditionalities obtaining in both the exporting and the importing countries.

8.7 Factoring Agreement

The master factoring agreement that is normally executed between the exporter and the factor can be of three types:
(i) Offer and acceptance,
(ii) Facultative type, and
(iii) Whole turnover type.

In all the three types, the relationship between the exporter and the factor is the same - being based on outright purchase of the trade-debts belonging to the seller, by the factor. However, the main difference between the three types of agreement is in relation to the time of passing of the ownership right to the factor.

In offer and acceptance, each time the offer of sale is made by the exporter through an invoice. The moment the same is accepted by the factor, the trade-debts pass on to him.

In facultative type of agreement, there is no formal acceptance of debt by the factor. If he does not expressly reject a debt offered, acceptance is deemed to have taken place and the debt vests in the factor.

Whole turnover agreement is a running concept whereby after execution of the agreement, all the debts remain vested with the factor. However, by inclusion of certain covenants in the agreement, the factor reserves his right to make prepayment only against the approved debts. It can be appreciated from the above that from prudent financial and operation angle, the whole turnover agreement is the most appropriate and convenient mechanism for factoring transactions.
8.7.1 Covenants in Factoring Agreement

From a factor's viewpoint, the most important function of the factoring agreement is to ensure that the debts purchased vest in him in absolute terms. Nevertheless, there should be a number of ancillary provisions which are essential to his security, for instance, his recourse to the exporter in case of breach of warranty, perfecting his title and right to debts purchased, etc. Similarly, the covenants in the factoring agreement must also indicate the extent of security available to the exporter. The legal experts with whom the researcher had the occasion to interact, in general, are of the opinion that the following provisions/covenants should, normally, be included in an ideal factoring agreement:

(a) Definition of various terms used in the agreement. These terms may include:

(i) Approved and unapproved debts,

(ii) Commencement date,

(iii) Offer & acceptance,

(iv) Maturity date,

(v) Base rate,

(vi) Territory,

(vii) Date of insolvency,
(viii) Termination of agreement,

(ix) Countries to which exports are taking place, etc.

(b) Normal warranties and undertakings by the exporter. These may include:

(i) That the particulars in the offer are correct and represent genuine and bona-fide trade transactions and that they are legally enforceable against the importer(s).

(ii) That the original invoice sent to the importer(s) contains required nature of assignment.

(iii) That on required to do so, he will provide evidence to the satisfaction of the factor of due delivery of goods (Proof of delivery).

(iv) That he will notify to the factor promptly about any dispute between him and any of his debtors.

(v) That he will purchase back the disputed debts, if required to do so, from the factor.

(vi) That he will hold, as a trustee, any money received from the importer(s) and remit the same immediately to the factor.

(vii) That he will permit the factor or his duly authorised agent to carry out inspection of the premises/books of accounts, etc.

(viii) That he will notify to the factor any change in the constitution, etc. which may affect the decision of the factor.
(ix) That he will pay taxes, duties, levies and other charges/ costs/expenses, etc.

(x) That no other person has any interest or charge or lien, etc. on the receivables factored and that he will not create any subsequent encumbrances.

(xi) That he is not in breach of his obligations to the importer and the importer will accept the invoices and goods.

(xii) That the importer has a place of business and is not an associate of the exporter.

(xiii) That he will not vary or cancel any of the sale contracts, already factored, without the prior consent of the factor.

(xiv) That he would give necessary power of attorney to the factor, whenever required to do so, to institute or defend proceedings in the exporter’s name and that such power of attorney would be irrevocable in nature.

(c) The factoring agreement should also contain the following clauses:

(i) Factor’s right on breach of any of the warranties, by the exporter.

(ii) Detailed provisions, rights, duties and obligations of various parties in case of termination of agreement.

(iii) Details of charges to be paid, and

(iv) Rules regarding arbitration in case of any dispute, etc.
8.8 Letter of Waiver

This is the vital legal as well as operational requirement. This is so because the exporter who is desirous of entering into a factoring contract with a factor, may already be enjoying certain credit facilities (including normal working capital for domestic purposes, term lending, pre-shipment credit, etc) from a bank and hence all his movable assets - both existing and future including export trade debts/receivables are charged to it.

Therefore, legally speaking, letter of waiver/disclaimer from the financing bank is to be obtained as otherwise the assignment of debt against the factor may be rendered void.

8.9 Ban on Assignment

This is a legal impediment causing hindrance to growth of factoring both domestic and international, in many countries of the world. It primarily means stipulating a condition in the purchase contracts by the debtors prohibiting the assignment of the rights or benefits by the supplier to a third party which may include a factor too. The famous Helstan Case in UK (Helstan Securities Ltd V. Hertfordshire - Country Council - 1978, 3 AER 262) is an often cited case in this regard. In the cited case, a contractor had entered into a contract with local authorities for providing certain services. The contract contained an explicit clause under which the contractor was precluded from assigning his

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right to a third party. However, the contractor assigned the debts to a finance company. On refusal by the local authorities to make payment to the finance company, the matter went to the court which held the assignment itself to be invalid.

Therefore, such a situation in international trade transactions covering Indian exports abroad may mean substantial loss to the exporters as the importers may not pay only to the factor but also to the exporter as the agreement itself may be void. Under the legal framework obtaining in USA under Uniform Commercial Code, prohibition of the assignment of debt in a sale-contract is not effective as regards the rights of the assignee of the debt.\(^\text{10}\) As stated in chapter 2, an effort in the above direction was made in the Unidroit Convention (Article 6(1)) stating that the assignment of a receivable by the supplier to the factor shall be effective notwithstanding any agreement between the supplier and the debtor prohibiting such assignment.

However, there was substantial argument against the above clause being included in the Convention on the ground that it interfered with the rights of the seller and buyer to enter into a contract freely. Therefore, as already stated, a compromise was struck by inclusion of the clause (Article 6(2)) that such assignment (by an exporter in favour of the export factor) shall not be effective against the debtor when, at the time of conclusion

\(^{10}\) *ibid*, p 132.
of the contract of the sale of goods, it has its place of business in a contracting state which has made a declaration under Article 18 of the Convention.

The above discussions imply that before entering into an export factoring agreement, the export factor has to ensure that the contracting state (the importer’s country) has not made a declaration under Article 18 of the Convention. It is an essential precaution which a factor has to undertake besides scrutinising the covenants of the contract of sale entered into between the exporter and the importer.

8.10 Retention of Title

Under this legal connotation, it is implied that the supplier of goods to a customer reserves his rights to recover from the insolvent customers, the goods supplied and actually still in possession of the customer but not paid for. This also gives an unpaid supplier rights to the following:

(i) Any goods (even those for which payment has been made) originating from the supplier for satisfaction of the indebtedness for all goods supplied and not paid for,

(ii) Any work in progress or finished products in which goods originating from the supplier are comprised and

(iii) Any indebtedness owing to the customer and arising from sub-sales of goods mentioned in (i) and (ii).
(i) and (ii) are usually referred to by fact internationally as **extended reservation of title** and (iii) as **prolonged reservation of title**.(11)

All these deliberations regarding rights of the unpaid supplier arose from the **Romalpha Case** (Aluminium Industries Vaassen BV V. Romalpha Aluminium Ltd -1976 2AER 552). This case decided in favour of the rights of the unpaid seller to the client of the factor not only in respect of the goods which were in possession of the client, but also those which were sub-sold and assigned to a third party.

The above provisions make factoring a risky proposition in a situation of a supplier becoming insolvent and the consequential recovery of funds from the debtors posing problem vis-a-vis the rights of the unpaid supplier of the client. This inevitably calls for close scrutiny of the purchase contracts of the exporters at the time of evaluation of a factoring proposal.

This conflict of interest between the unpaid for supplier of the exporter and the factor may become more apparent in international trade transactions wherein the insolvent client (i.e. the exporter) may have creditor and debtor (i.e. the importer) in the same country. Under such a situation, the law of the importer’s country would be applicable and the interest of the export factor may further be in jeopardy.

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8.11 Priority of Assignment

Legally speaking factoring implies outright purchase of trade debts by a factor. Hence, even if the client is a corporate entity, there is no need of registration of charge with Registrar of Companies (RoC) under Section 125 of the Companies Act, 1956. As regards domestic factoring, rules are very clear as far as the priority of assignment is concerned. In absence of requirement of notice to the debtors to make valid assignment (Section 130 of Transfer of Property Act, 1881), the general rule in Dearie vs Hall (by which it has been stated that as between two assignees, the first to give notice to the debtors has the prior right provided that he was not aware of an earlier assignment at the time of assignment to him) would apply.\(^{12}\)

But, the same principle may not be applicable in respect of international trade transactions in view of conflicting laws obtaining in different countries regarding validity and priority of assignments. Unidroit Convention is silent on this issue. In the opinion of the researcher such a conflict should be governed by the laws of the country where the debtors are located.

This reinforces the argument that intimate knowledge about the legal framework of the importers’ countries is an essential pre-requisite for launching international factoring activities.

\(^{12}\) ibid, p 148.

Thus far, we have discussed the general legal provisions primarily based on Unidroit Convention, which should be taken care of while launching internation factoring services in the country. However, the specific provisions of FERA and exchange control manual related to export of goods/services also deserve some discussions as it is felt that some modifications thereto may be needed before starting this service.

8.12.1 Payment for Exported Goods

Section 18 of Foreign Exchange Regulation Act, 1973 provides for measures towards proper control over realisation of exports from India. Section 18 (1) (a) prohibits the exporters from taking or sending out by land, sea or air all goods or class of goods specified in the notification from India directly or indirectly unless the exporter furnishes to the prescribed authority a declaration in the prescribed form regarding the value of export of goods. This form of declaration is what is known as GR/PP forms prescribed for that purpose.

The GR/PP forms (duplicate copy) together with the shipping documents are to be submitted to the authorised dealer (a bank) within a specified period from the date of shipment, for negotiation purpose. In case export factoring is introduced in India, such documents are to be presented to the export factor. The issue is whether the export factor
under such circumstances can handle the documents in absence of the status of authorised dealer. The question is to be discussed from two perspectives:

(i) When the bank itself is undertaking factoring activities through a department/division, and

(ii) When such an activity is undertaken by a separate organisation whether or not the subsidiary of a bank.

In the first instance, there is no problem at all in as much as the activity is undertaken by the authorised dealer itself. Therefore, in such cases, the exporter will be submitting the duplicate copy of the GR/PP forms alongwith shipping documents to the factoring division of the authorised dealer, which in turn will transmit the same to its international division for negotiation.

Even in the second instance, sufficient safeguard is available under Section 18(8) of FERA, 1973 which reads as: “Without prejudice to the provisions of sub-section (1), where the Reserve Bank has permitted any authorised dealer to accept, for negotiation or collection of shipping documents covering exports from his constituent (not being a person who has signed the declaration in terms of sub-section (1)), such authorised dealer shall, before accepting such document for negotiation or collection, require the constituent concerned also to sign such declaration and thereupon such constituent shall be bound to comply with such requisition and the original declarant and such constituent signing the
declaration shall be considered to be the exporter for the purposes of this section, and shall be governed by the provisions thereof accordingly."

Under the above provision, the authorised dealer can accept for negotiation, all shipping and other documents covering exports from their constituents who are not the original exporters but have signed the declaration on the export forms. This implies that an export factor can accept the shipping and other documents from the exporter, append its counter signature and forward the same to the authorised dealer for negotiation.

However, the situation would be quite different if the export factor itself decides to negotiate the export documents based on duplicate GR/PP form along with the other shipping documents. Under the prevalent legal framework, it cannot undertake the aforesaid activity unless it gets the status of authorised dealer. Therefore, if international factoring is to make headway in India, the export factor (an organisation other than a bank) must be given the status of an authorised dealer.

8.12.2 Responsibility Towards Realisation

At present under Section 18 of FERA, an exporter is fully responsible for realisation of export proceeds. However, on introduction of international factoring, the situation may be different in as much as the export receivables are purchased by the export factor. Simultaneously, under Section 18 (8) as discussed above, both the original exporter and the authorised dealer (factor) who has affixed its counter signature on the relevant documents shall be governed by the provisions of the Act meaning thereby that
both would be held responsible towards realisation of export proceeds. Resultant effect can be disastrous in terms of the export factor getting caution listed by Reserve Bank and Enforcement Directorate proceedings against him, in case the export receivables are not realised in time. Therefore, it is suggested that Section 18 of FERA should be suitably amended with provisions as under:

(i) In case export factoring is undertaken on with recourse basis, the responsibility of realisation of export proceeds shall continue to remain with the exporter, and

(ii) In case export factoring is undertaken on without-recourse basis, the exporter shall be absolved of his responsibility towards realisation of export proceeds. This responsibility shall vest in the export factor. However, the penal provisions like caution-listing or enquiry by Enforcement Directorate, etc. may not be strictly adhered to unless through constitution of an enquiry, Reserve Bank comes to a tentative conclusion regarding involvement of the factor in perpetration of a fraud.

8.12.3 Payment of Commission

In international factoring transactions, the commission payable to the import factor towards services rendered, is decided ab-initio though the actual payment takes place after remittance of the amount by the import factor to its exporting counterpart, on realisation of export debts. Two settlement procedures are possible in this regard. Either
the import factor while keeping the commission payable to itself, may remit the remaining amount; or the import factor remits the entire export proceeds whereafter the export factor sends to it the commission payable under the agreement. Under the existing provisions in India, the first option is not permissible as the entire export proceeds are to be remitted to the country. Under the second option, nomenclature of import factor is not in existence to which commission can be paid. Therefore suitable amendment may have to be done in FERA, whereby payment of commission to import factor, may become a permissible mode of payment.

8.13 Conclusion

These are some of the important legal provisions which either need a thorough scrutiny or suitable amendments thereto before international factoring can be launched in India on a sound footing. However, the most important aspect remains that India may first have to ratify and accept the Unidroit Convention in order to get the status of a contracting state to follow and abide by the rules framed therein.