

# *Legal Updates*

*Vinod Kothari & Company*

## Legal Issues on factoring business in India

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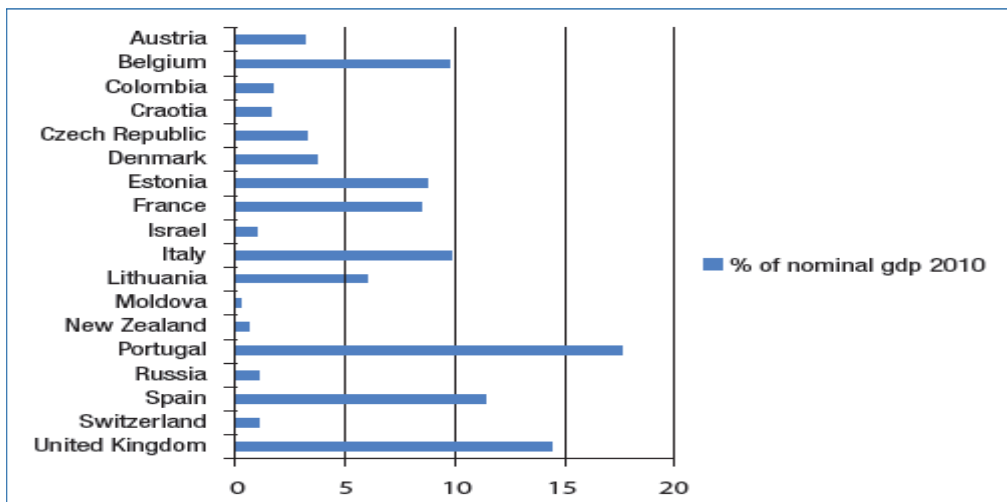


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Credit Factoring or simply factoring is an asset backed means of financing (tripartite agreement between the buyer, seller and the factor), whereby the account receivables are assigned to a third party called factor for a discount, releasing the tied-up capital and providing financial accommodation to the Company. The origin of factoring goes back to 14<sup>th</sup> century in England. Earlier, factoring was confined to textile and garment industries, but later was spread across various industries and markets. Factoring has been defined as:

“Credit factoring may be defined as a continuing legal relationship between a financial institution (the “factor”) and a business concern (the “client”) selling goods or providing services to trade customers (the “customers”) whereby the factor purchases the client’s book debts either without or with recourse to the client, and in relation thereto controls the credit extended to customers and administers the sales ledger.”

Though Europe provides largest volumes globally, factoring in Asia has been growing rapidly in the last few years. The penetration rate<sup>1</sup> of factoring in various countries is as below:



<sup>1</sup> IFG, March, 2011 Newsletter,

[http://www.ifgroup.com/files/images/data/020110331145023newsletter\\_24\\_mars2011.pdf](http://www.ifgroup.com/files/images/data/020110331145023newsletter_24_mars2011.pdf)

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The purport of factoring is to assign the account receivables to be able to a) instantly convert receivables into cash, that enable the companies to have funds to finance the day to day operations of the company, b) helps in efficient collection of the receivables and protection against bad debts, c) outsourcing sales ledger administration and d) availing credit protection for receivables.

Typically in a factoring transaction, a seller gets a prepayment limit from the factor, then enters into a transaction with the buyer and submits the invoice; notice to pay etc to the factor. The factor makes upfront payment to seller, as a percentage of invoice value based on criteria, such as, quality of receivables, number and quality of the buyers and your requirements (80% - 95% of invoice value) and maintains the sales ledger of the seller and collects payment from buyer. The balance payment is made to the seller, net of charges. The seller is not be required to open an LC or a bank guarantee.

The cost to the seller in factoring is the service fees, which is dependent on a) sales volume, b) number of customers, c) number of invoices and credit notes and d) degree of credit risk in the customer or the transaction.

### ***Factoring and Bill Discounting***

There is a very thin line of difference between factoring and bill discounting. Bill discounting unlike factoring is always with recourse to the client, whereas factoring may be with recourse or without. Generally there is no notice of assignment given to the customer in case of bill discounting and collections are done by the lender, unlike factoring, where debt collection is done by the factor. Factoring can be called a financing and servicing function, whereas, bill discounting function is purely financial.

### ***Types of Factoring***

#### **On the basis of geographical distribution**

1. Domestic Factoring
  - a. Sales bill factoring
  - b. Purchase bill factoring
2. International Factoring – As international trade continues to increase, international factoring is being accepted as vital to the financial needs of the

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exporters and is getting the necessary support from the government, specifically in the developing countries to stimulate this mode of funding.

- a. Export factoring – It is seen as an alternative to letter of credit, as the importers insist on trading in open account terms. Export factoring eases the credit and collection troubles in case of international sales and accelerates cashflows and provides liquidity in the business.

### On the basis of credit risk protection

- On recourse basis, wherein the factor can recover the amount from the seller, in case of non-payment of the amount to the factor. Thus, though the receivables have been assigned, the credit risk remains with the client.
- On non-recourse basis also called *old line* factoring, wherein the risk of non-payment of invoices is borne by the factor. However, the factor only bears credit risk in such transactions. In case non-payment is due to any other reason other than financial incapacity, the factor

### Other types:

- Advance factoring: In case of advance factoring, the factor provides financial accommodation and non-financial services. The factor keeps a margin while funding, which is called the client's equity and is payable on actual collection.
- Maturity factoring: Here, the factor makes payment on a due date. This sort of funding is resorted to by clients who are in need of non-financial services offered by the factors.
- Supplier guarantee factoring: Also known as drop shipment factoring. This sort of factoring is common where the client acts as a mediator between the supplier and the customer.

### Overview of factoring in India:

India's factoring turnover in 2009 was around Euros 2500 Million in domestic and Euros 2650 million in total as compared to a total of Euros 1,283,559 million worldwide<sup>2</sup> and the turnover over the last 7 years has seen a tremendous growth and steep downfall as

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<sup>2</sup> Data from Factors Chain International [http://www.factors-chain.com/?p=ich&uli=AMGATE\\_7101-2\\_1\\_TICH\\_L1403780046](http://www.factors-chain.com/?p=ich&uli=AMGATE_7101-2_1_TICH_L1403780046)

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well; while that of Asia has risen 219% from 2004 to 2010 and is valued at \$637 billion. Some of the challenges faced by the factoring companies in India are a) there was no specific law for assignment of debt, b) there was no recovery forum available to the factoring NBFCs such as DRT or under Sarfaesi Act, c) Lack of access to information on credit worthiness and d) assignment of debt involves heavy stamp duty cost.

### **UNICITRAL laws on assignment**

The United Nations Convention on the Assignment of Receivables in International Trade was adopted to facilitate availability of credit and capital. Article 2 of the Convention defines Assignment as –

*“Assignment” means the transfer by agreement from one person (“assignor”) to another person (“assignee”) of all or part of or an undivided interest in the assignor’s contractual right to payment of a monetary sum (“receivable”) from a third person (“the debtor”). The creation of rights in receivables as security for indebtedness or other obligation is deemed to be a transfer;*

The definition covers both the creation of security rights in receivables and the transfer of full property in receivables, whether or not for security purposes. Further, the Convention defines receivables as contractual right to payment of a monetary sum and includes parts of and undivided interests in receivables. Also included are loan receivables, intellectual property licence royalties, toll road receipts and monetary damage claims for breach of contract, as well as interest and non-monetary claims convertible to money. The term does not include a right to payment arising other than by contract, such as a tort claim or a tax refund claim. The Convention generally does not apply to domestic assignments of domestic receivables, but some of the clauses as stated are relevant adaption and include the following:

- Notice of assignment of receivables is required to be given to the debtor and is effective when received by the debtor. An assignment does not affect the rights and obligations of the debtor, without the consent of the debtor.
- The assignee may not retain more than the value of its rights in the receivables.
- The assignor makes representation that the debtor shall not have the right of set-off.
- The law of the State in which the assignor is located governs the priority of the right of an assignee in the assigned receivable over the right of a competing claimant.
- The Annex to the convention states that the

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- Right of an assignee in an assigned receivable has priority over the right of an insolvency administrator and creditors who obtain a right in the assigned receivable by attachment, judicial act or similar act of a competent authority.
- The registration system should be operative to register details with regard to the assignor, assignee and brief description of the assigned receivables and may be with regard to existing or future receivables.
- The priority of the right of an assignee in the assigned receivable is determined by the order in which notification of the respective assignments is received by the debtor.

As the Convention is a model law, it does not contain a uniform substantive law rule as to the formal validity of the assignment, but is indicative of the aspects to be covered in assignments.

### ***The Regulation of Factor (Assignment of Receivables) Bill, 2011***

In order to revive the business and render liquidity specifically to the small and medium enterprises, the Finance Minister in the last Parliament session had tabled a pilot bill to bring the factors business in India under regulation.

While the intent of the Bill may be to stimulate the growth of factoring business in India, but a close look at the Bill does not enumerate so. The Bill is a regulation Bill, but the much need is for a Bill to promote factoring and not so much to regulate. Some of the highlights of the Bill are as mentioned below:

- The Regulation of Factor (Assignment of Receivables) Bill, 2011, the name makes it unclear whether the Bill is for regulating assignment; factoring or both. Further it should have been a regulation of factor's' and nor factor, to be more appropriate.
- Section 2 (a) of the Bill defines *assignment means transfer by agreement, of undivided interest of any assignor in any receivables due from any debtor...* The definition talks about undivided interest to be assigned only and does not consider assignment of fractional interest within its ambit. This would mean that any assignment of fractional interest would not be covered under this definition. Further whether the assignment could be in terms of money, in terms of time or rate of interest is not clear from the definition.
- The definition of receivables, in Section 2(p) of the Bill includes futures receivables as well, which is in line with international laws.
- Section 3(1) of the Bill says –

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*No Factor shall commence or carry on the factoring business unless it obtains a certificate of registration from the Reserve Bank to commence or carry on the factoring business under this Act.*

The definition should have said no **'person'** shall commence or carry on the factoring business rather than using the term factor. A person shall only become a factor after obtaining a certificate of registration from the Reserve Bank as the section suggests. However the section already terms such person as factor, making the definition circular.

- Section 3(3) of the Bill states every company carrying or commencing factoring business to be registered with RBI, and such companies would be classified as NBFCs and all the provisions applicable to NBFCs would be applicable here as well. Section 3(4) requires existing NBFCs to take a fresh certificate of registration, if they are principally engaged in the business of factoring. However the question to be considered is whether companies carrying out the business of factoring can be classified as NBFCs as per the definition provided in Section 45I(c) and Section 45I (f) of the Reserve Bank of India Act, 1934. The definition of a financial institution as stated in the Act is:

1[(c) “financial institution” means any non-banking institution which carries on as its business or part of its business any of the following activities, namely:–

- (i) the financing, whether by way of making loans or advances or otherwise, of any activity other than its own:

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4[(f) “non-banking financial company” means–

- (i) a financial institution which is a company;
- (ii) a non-banking institution which is a company and which has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner, or lending in any manner;
- (iii) such other non-banking institution or class of such institutions, as the Bank may, with the previous approval of the Central Government and by notification in the Official Gazette, specify;]

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Section 45I (c) requires the companies to carry on the business of financing, apart from other businesses listed to be classified as a non banking financial company. The question for consideration here is whether factoring business, is a business of financing or insurance. We have discussed this issue in detail below.

- Section 7(3) states that in case the receivables are encumbered to any creditor, the assignee shall pay the consideration for such assignment to the creditor to whom the receivables have been encumbered. In case of fixed charge created over assets, the provisions of this section are well thought, as, if the consideration was paid to the assignor, it would have resulted in double funding. However in case of floating charges, this would render several difficulties for the assignor. Most companies have fixed and floating charges created over their assets, the assets on which floating charge is created are regularly rotated in business and are only crystallized in case of default or non-payment, thus it would be difficult to crystallize the assets by the factor and the creditor to whom assets are encumbered and floating charge is created.
- Section 8 of the Bill requires the notice of assignment to be given to the debtor, without which the assignee shall not be entitled to demand payment of the receivables from the debtor. However Section 7(2) of the Act, makes Section 8 redundant, as it states that on execution of agreement in writing for assignment of receivables, the assignee shall have *'absolute right to recover such receivable and exercise all the rights and remedies of the assignor whether by way of damages or otherwise, or whether notice of assignment as provided in sub-section (1) of section 8 is given or not.'* This is not on line with the proviso to Section 130 (1) of the Transfer of Property Act, 1882 which mandates that the assignee will be able to entitle to recover or enforce the debt when the debtor is made party to the transfer or has received express notice of such an assignment and also as stated in the UNCITRAL model law on assignment.
- Section 8, 9 and 10 provide for the requirements of notice of assignment. The intent of Section 11 seems that even in case notice of assignment is not provided the debtor would not be absolved from his duties to make payment. However the section is worded as *'till notice is served on the debtor, the rights and obligations in its contract with the assignor, shall remain unchanged, excepting the change of the party to whom the receivables are assigned which may become entitled to receive the payment of the receivable from the debtor;'* this means whether or not notice for assignment is provided the rights and obligations of the debtor towards the assignee would remain unaffected. If so was the intent of the Section, then there was no need for any notice of assignment to be given to the debtor, as by the virtue of this section read with section 7(2), the assignee would have all the right

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on receivables as that of the assignor. The UNCITRAL model law on assignment requires that notification of assignment of debt is to be given by either the assignor or the assignee, the assignee may not retain more than the value of its right in the receivable and notification of the assignment or a payment instruction is effective when received by the debtor. However, until the debtor receives notification of the assignment, the debtor is entitled to be discharged by paying in accordance with the original contract.

- Import factoring is not permitted as per Section 31(1) of the Bill
- Further recourse to the assignor is not permitted under the Bill.
- The proposed law provides for compulsory registration of every transaction of assignment of receivable with the Central Registry to be set up under the SARFAESI Act within a period of 30 days.

### ***True sale or mere financing?***

The factoring business in India was carried out on both with recourse and without recourse basis prior to the Bill. The question for consideration is whether factoring is an agreement of true sale or mere mode of financing in the garb of transfer of receivables. In one of the landmark judgment's of *Major's Furniture Mart, Inc v. Castle Credit Corporation*, 602 F.2d 538; 1979 U.S. App. LEXIS 13808; 26 U.C.C. Rep, the question in consideration in the case was whether the transaction was a true sale or mere financing. Major's was into retail sale of furniture and Castle into the business of financing such dealers as Major's. Under an agreement, Major's had sold its receivables to Castle, with full recourse against Major's. The Court held the assignment of receivables by the furniture seller to the factoring company a case of financing and not assignment, as the factor had full recourse on the seller and the factor only paid a part of the total debt factored by him.

In another case of *Endico Potatoes, Inc., and others vs. CIT Group/Factoring, Inc.*, Second Circuit Nos. 1751, 1961 Decided: October 2, 1995, in case of a factoring transaction, the court opined:

"Resolution of whether the "contemporaneous transfer," as CIT describes Merberg's assignment of accounts receivable to CIT and CIT's loan advances to Merberg, constitutes a purchase for value or whether the exchange provides CIT with no more than a security interest, depends on the substance of the relationship between CIT and Merberg, and not simply the label attached to the transaction. In determining the substance of the transaction, the Court may look to a number of factors, including the right of the creditor to recover from the debtor any deficiency if the assets assigned are not sufficient to satisfy the debt, the effect on

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the creditor's right to the assets assigned if the debtor were to pay the debt from independent funds, whether the debtor has a right to any funds recovered from the sale of assets above that necessary to satisfy the debt, and whether the assignment itself reduces the debt.

Major's Furniture Mart, Inc. v. Castle Credit Corp. , 602 F.2d 538, 543-46 (3d Cir. 1979); Levin v. City Trust Co. , 482 F.2d 937, 940 (2d Cir. 1973); Hassett v. Sprague Electric Co. , 30 B.R. 642, 647-48 (Bankr. S.D.N.Y. 1983); In re Evergreen Valley Resort, Inc. , 23 B.R. 659, 660-61 (Bankr. D. Me. 1982). The root of all of these factors is the transfer of risk. Where the lender has purchased the accounts receivable, the borrower's debt is extinguished and the lender's risk with regard to the performance of the accounts is direct, that is, the lender and not the borrower bears the risk of non-performance by the account debtor. If the lender holds only a security interest, however, the lender's risk is derivative or secondary, that is, the borrower remains liable for the debt and bears the risk of non-payment by the account debtor, while the lender only bears the risk that the account debtor's non-payment will leave the borrower unable to satisfy the loan.

In a more recent case<sup>3</sup> of Re: Qualia Clinical Service, Inc v. Inova Capital Funding, LLC; Inova Capital Funding, Inc, the bankruptcy appellate panel for the eighth circuit found that the invoice purchase agreement was clearly and unambiguously a financing arrangement. The court made that finding on the terms of the agreement itself. In particular, the court noted that, the recourse provisions contained in section 7.02 of the agreement, which shift all collection risks to Qualia.

“..... "The question for the court then is whether the Nature of the recourse, and the true nature of the transaction, are such that the legal rights and economic consequences of the agreement bear a greater similarity to a financing transaction or to a sale.”

This agreement, which shifts all risk to Qualia, is a disguised loan rather than a true sale. Where the "seller" retains "virtually all of the risk of non-collection," the transaction cannot properly be considered a true sale.

If the assignment alone did not reduce the obligation of the assignor towards the assignee and the assignee at any given point of time, directly demand the money from the assignor, there is no transfer of risk. If the primary risk of customer's non-payment remained with the assignor, then it cannot qualify as a true sale. Hence if the factoring business is carried out without recourse to the assignor, it would not be a financing transaction and can be classified as an NBFC.

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<sup>3</sup> <http://www.law.com/jsp/tal/PubArticleTAL.jsp?id=1202482639423&slreturn=1&hbxlogin=1>