

## FACTORING - INSTRUMENT OF FINANCING IN BUSINESS PRACTICE –SOME IMPORTANT LEGAL ASPECTS

### Abstract

*Successful business practice needs constant sources of financial means. One of the biggest problems of business practice is how to provide these financial means. Among many other methods, business practice is using factoring as a method of financing. Factoring, as a special method of financing, is realised in practice by factoring contracts.*

*Factoring contract is a legal transaction based on the institute of assignment, under which the creditor assigns its receivables to factor (generally specialized companies).*

*Factoring has some common functions, first and most important of these functions is the function of financing (of the supplier). Other functions of factoring like advance payment, book keeping, regarding claims, collecting of the claims, protection against failures of payment are also very important.*

*Commercial practice has developed numerous forms of factoring agreements. In spite of their diversity, all kind of factoring agreements have certain common characteristics in terms of their subject matter, conclusion, effect, termination etc.*

*The factoring contracts are not fully encompassed by existing provisions of the law, but are regulated under the UNIDROIT Convention on International Factoring.*

*In this article, the authors are analyzing characteristics of factoring and the factoring contract.*

**Keywords:** *factoring; factoring contract; assignment of short-term claims.*

### 1. INTRODUCTION -THE CONCEPT OF FACTORING AND ITS IMPORTANCE

While fulfilling their business activities on the market commercial subjects are encountering a number of problems which make practical realization of their business tasks more difficult. Rapid development of technologies (production, transport, business etc.) leads to evident enlargement in scope and speed of business operations as well as the rapid development of business network; in the conditions of even more developed and larger market problems related to business operations are becoming bigger and bigger.

The largest numbers of difficulties which inevitably follow modern business operations are predominantly of financial nature, firstly problems of liquidity in general, and the questions of creditworthiness (conditions for obtaining credit), risk of claim payment, costs etc.<sup>1</sup>. Enlarging the scope of exchanging the goods and services in international business relations the problems are additionally multiplied due to the presence of different sovereignties and

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accordingly different legal regulations in the field of finances and banking.

Questions of financing, crediting (as a form of financing), as well as performing certain operations for others (with compensation), appear as very significant and actual when fulfilling business transactions, on national as well as international level. Instruments, methods and techniques through which crediting is performed in contemporary conditions of financial business are very different; one of these “techniques” or instrumental forms (which has proven to be very successful) is factoring (business). Factoring is a form (or an instrument) of financing, which originated, as many other “contemporary” business forms, in practice of USA, from where it spread rapidly and “conquered” other countries with developed market commerce. Since it is very useful as the source of financing, primarily short term (trade financing)<sup>2</sup>, factoring has had a very successful affirmation in transition and developing countries.

By its nature factoring is a banking operation which falls into the group of special credit operations<sup>3</sup>. In economic terms, factoring represents a technique of clearing commercial claims, which is significantly improving liquidity of participants in commercial exchange and cutting down business expenses. By using this financial technique the client cedes to the factor, the bank or maybe some other specialized financial institution, (undue) claims it has towards third persons on the basis of (different) contracts, for the collection of (those) claims.

Factoring (business) is performed through the factoring contract, contractual relation (agreement) between the creditor (client, exporter – the supplier) and factor (bank or other specialized financial organization) on the basis of which the claims or payment risk are assigned from the client to the factor (bank).

In legal theory the factoring contract is generally considered as a kind of contract in which one party – the factor binds to take over still undue short term claims of the other party – the client, to collect them, and to pay the client the counter value of claims right away or in precise short period of time and to guarantee the payment under certain conditions, and the client binds to pay the corresponding compensation to the factor<sup>4</sup>.

Factoring contract is a two-way binding contract with standing execution of prestations; since the characteristics of contractual parties are very important in factoring, this is a contract *intuitu personae*. The contract is formal which is understandable having in mind its value and importance; in business practice this contract is most often performed as adhesive contract<sup>5</sup>. Factoring contract is generally innominate contract since the number of countries which have legally regulated this contract is considerably lower of the number of those which have not done that.

In factoring contracts many elements of classical contracts can be seen, before all the elements of cession contracts, then credit contracts, guarantee contracts, service contracts, commission contracts and *escont* and *lombard* (credit) contracts<sup>6</sup>. Regardless to having lots of common elements with abovementioned contractual agreements factoring contract cannot be equaled with them, on the contrary. Factoring contract distinguishes itself from cession in wideness of prestations which are offered to the client (cession is a technique in which undue claims are transferred in factoring business); from *escont* credit contract, whose subject is purchase of effects, it differs in guarantee of factor for billability of claims and inability of claim

(against the client in case of not being able to collect the debts from the debtor); it differs from service contracts by the character of operations the factor performs for the client. Factoring contract differs significantly from commission contract since the factor does not conclude the contract with the third party as a commission agent but acts towards it in its name and on its behalf; factoring differs from lombard credit since there are no elements of mortgage in it.

Having in mind everything that has been said, we can treat factoring contract as a specific – sui generis contract.

## 2. HISTORY OF FACTORING

Factoring business was created in international trading in the period connected with the development of new markets<sup>7</sup>. With the growth of needs to ensure the placement of goods and collect the demands in the markets (of far away) overseas countries primarily therefore in foreign trading exchange between the USA and England new ways, instruments and techniques of making business are starting to be used.

Factoring business has developed from the commission business; in XIX century the risk of international trading was very big, therefore the English textile factory owners who, at that time, exported their products to American market (which was not known to them), hired the agent to make the sale of their goods on commission. American agents in time have widened the scope of their activities by testing the solvency of the buyers as well as performing a number of administrative and other operations on behalf of the client. In that way the agents took over the complete taking care of the goods from the moment it is loaded in some port till the collection of claims<sup>8</sup>. With further development of business operations the agents have, upon factory owners' demand and naturally with increased commission, agreed to guarantee also for the solvency of the buyers, so in the moment of delivery the already approved arranged amounts of down payment, which actually represented the payment of selling price with the deduction of agent's commission (compensation). In time these operations took the character of performing collection services, with or without taking over the risk of collection and financing the client (deliverer), with which the primary commission business grew into a new specific business – factoring business. Alongside with the transformation of commission into factoring business, the subjects that were performing this business also transformed; instead of trading companies, which were performing commission and other businesses, factoring business was more and more taken over by the banks from which some were specialized for such business.

Factoring was created in international exchange, but has achieved full affirmation (also) in domestic trading exchange, especially in the USA. In European countries factoring has appeared a bit later (which is, by the way, the case with all other business products of trading practice). In Europe factoring was firstly accepted in Germany, and then afterwards in other developed countries also, its development was especially important in Italy and Sweden.

In contemporary market conditions, countries in transition also use this business method often, which is completely understandable having in mind the great need for financial assets which appears chronically with commercial subjects from these countries; apart from that, the motive for its usage is also its »practicability« and relative simplicity in application,

which represent surely an additional motive for the application of this financial instrument.

### 3. SOME SIGNIFICANT ADVANTAGES AND DISADVANTAGES OF FACTORING

Factoring, as a special financial technique, significantly improves liquidity of participants in commercial exchange and reduce business expenses by providing and accelerating the payment of claims and, in the same time, unburden the legal and financial structures of the trade organisations-participants on market of goods and services, leaving them more time and space for other business tasks<sup>9</sup>.

Factors are financially strong and specialised to make a great number of services with relatively low costs.

From the financial point of view advantage of factoring is the growth of liquidity of the business subjects, but of the trade in general as well<sup>10</sup>.

Factoring is especially important and convenient for small and medium size enterprises<sup>11</sup>, their position on the market improves significantly by using factoring technique.

Financing is more important for the client, the fact that the financial means are available when they are needed and that business on the market can go on without delay is the biggest advantage of all<sup>12</sup>

For the client of the factor's organisation (seller or performer of services) the fact that factor is taking all risks of collecting the claims is very important. Naturally the costs of such a type of factoring is higher.

Collecting the claims and other services done by the factor (book keeping, analyzing the market ect.) are also very important because they unburden the client of many tasks and obligations and make the possibilities for him to concentrate on trade and business.

Insurance of collecting the payment by way of factoring is cheaper than classical insurance (which make the whole expenses of factoring smaller).

Financing by way of factoring is only short time financing, that fact can be disadvantage. Also factoring is generally arising in cases when factor is sure of the capacity for paying of the debtors.

Generally factors are financing the clients with higher business turnover<sup>13</sup>

Interests of the parties in factoring contract are different so advantages and disadvantages can change depending of the point of view.

Disadvantage of factoring for the client eventually can be the cost of factoring, which (sometimes) can be high.

Disadvantage of factoring from factor's point of view is the risk of insolvency or other obstacles in collecting the (client's) claims.

### 4. SUBJECTS IN FACTORING BUSINESS

In factoring business regularly appear many participants in business operations; these are, firstly the factor, then factor's clients (the exporter, the seller), debtor (client's co-contractor on the basis of a contract on trading goods, most frequently the buyer in sales agreement), so called »correspondent factors« appear in complex business of international factoring (factoring

organizations from abroad that participate in realization of factoring business).

Specific forms of factoring businesses (which appear especially in anglo-saxon countries) imply (also) a larger number of subjects, participants in business.

Factoring business is usually practiced by specialized firms – factors. Nowadays there are an extremely large number of companies in the world that were specialized for performing factoring business. On national level, most of independent factoring organizations are founded by banks (domestic and foreign), apart from that, banks can perform this business in departments<sup>14</sup> (specialized for that business tasks).

On international level numerous factoring companies<sup>15</sup> are most often associated in multinational and trans-national factoring companies; the most famous are four such networks<sup>16</sup>. Great financial power of these multinational networks is based on participation of a large number of banks, insurance and reinsurance companies and other financial institutions (as direct members of the network or share holders of member companies).

Apart from financing, important aspect of factoring organizations' dealings for the client is in the fact that factoring organizations are well acquainted with the state of liquidity of participants in the market, therefore the use of their services (for the client) significantly lowers the risks of claim collection; risks are of course taken over and beard by factoring organizations.

Seen from the economic point of view by taking over the collection of demands (even in the cases when creditors and debtors are barely solvent) factors influence the raising of general liquidity level of commercial subjects and the economy in general, where they improve also the security of business, especially when it is a case of international transactions (which are by the way even more complicated<sup>17</sup>).

## 5. FUNCTIONS AND THE RELATIONS OF PARTICIPANTS IN FACTORING BUSINESS

Factoring business has several functions which accomplish financial and legal security of collecting claims; all functions of factoring are of very big importance<sup>18</sup>.

Since the factoring represents (a very important) source of financing of current assets in contemporary economy<sup>19</sup>, we could say that the financing (crediting) is the most important function of factoring.

Security of the collection of claims is also an important function of factoring; the factor, in fact, takes care of the liquidity (credit worthiness) of the debtor, so in case that the debtor does not fulfill its commitments, he renounces the right to debt redemption for the amount which has already been paid to the client.

Apart from these two (essential) functions factoring also has a service function<sup>20</sup>, the factor organization keeps prompt evidence of the collection of claims from the buyer, about the date when claims are due for collection towards the buyers, tests the credit worthiness (liquidity) of the debtors, keeps books for the client, calculates taxes and commissions, expenses etc. Among these important services the factor can also perform other services, which are not directly connected to factoring contracts, but have indirect importance on their realization (testing and analysis of market, turnover statistics etc.).

In factoring business regularly appear three subject participants that enter into mutual relations, these are the factor, the seller (deliverer) of the goods, that is the performer of service (client) and the buyer that is the user of service (which appears in this relation in the role of the debtor).

Subject participants of three – side business relationship enter into mutual relations; the factor and the client conclude a factoring contract, on the basis of which the client transfers one or more claims (towards to its debtor) to the factor, and in return receives the compensation in a specified percentage from transferred claims. Regularly this percentage is around 80 – 90% of assigned claims. Upon the conclusion of factoring contract the debtor has to be informed that in the future their contract commitments with the seller that is the performer of the service will be regulated with the factor<sup>21</sup>. In the business of export (international) factoring, even more subject participants in the business appear; these are the domestic factor, domestic exporter, foreign correspondent factor and the importer. Domestic factor in this complex business assigns claims to correspondent factor for collection. Another variant of export (international) factoring is possible where the domestic factor enters into direct contact with the importer through its foreign subsidiary. As it has already been said, financing the seller of goods that is the performer of services, which is done through factoring, is the most important function of factoring business.

Assigned claims are paid up just after the transfer that is at latest till the due date; in that way the clients ensure the necessary liquidity by getting money assets that allow them to purchase the goods from the supplier, at reduced prices. Factor companies perform the services of claim collection; it is possible that the client company transfers onto the factor (assign to it) all its claims against (all) its debtors (global claims cession), relieving in that way from the duties related to the collection of all those claims and directing all its attention to its basic and regular activity; (possible) negative consequence of this “global cession” can be an increased level of “connectedness” to the factor and “dependence” on the factor in business activities. In factoring business the factor can renounce the right of recovery in relations towards the client, by which he takes over the role of guarantor of collection of its claims (del credere factoring). In order to maximally reduce the risk of inability to collect the claims the factor takes over upon him to test the credit worthiness of client’s debtors. In factoring contracts the factor reserves the right to, in case of low credit worthiness of a debtor, refuse to guarantee for the collection of its debt. In this case, (unlike in “del credere” factoring) the risk of collection is on the client. It is understandable that factoring with guarantee implies larger compensations for the factoring organization. The factors are regularly contracting allowed limit of the amount of claims per single debtor, which is not time limited and is renewable (revolving).

Apart from the services of claim collection, the services of the factor regularly include also the book keeping on behalf of the client. In import-export businesses, the role of factors is especially important, since them by taking over certain commitments (collection of claims, testing credit worthiness etc.), ensures continuous and unobstructed functioning of business.

## 6. TYPES OF FACTORING

Depending on different criteria there are few divisions of factoring business (and contracts related to them)<sup>22</sup>. Having in mind the fact that factors can perform several different functions that are very important for factoring business, one of the most important divisions of factoring business has in its base the scope of functions which are within a certain factoring business. Depending on which of (possible) functions are realized in a particular factoring business (crediting, payment ensuring, rendering professional services) there are “real” factoring, in which all these functions are present and » quasi « factoring where some functions are missing; primarily the function of taking over the risk of insolvency of the debtor<sup>23</sup>.

In “real” factoring the factor takes over the client’s short term claims from the contract (on sales of goods or service rendering) with the third party, undertakes advance payment (crediting) of the client, keeping business evidence that is bookkeeping, as well as taking over the risk of insolvency of the buyer (debtor from the contract on the sales of goods or rendering of services).

Apart from this (the most important) there is also the division into “open” factoring and “undisclosed” factoring<sup>24</sup>. This division is particularly specific for anglo-saxon law. In “open” factoring the exporter (client) cedes onto the factor its claims against the foreign buyer, having at the same time the duty to inform the foreign buyer about the claim cession and invite him to pay up the owed price to the factor.

There are two “variants” of “open” factoring, in the first one the exporter definitively transfers its claims against the foreign buyer to the factor and stops being the party in basic business, in his place comes the factor as claimant (claim cession). For assigned claim the factor pays to the client (exporter) a specific value of that claim, with the deduction of interest, expenses and commission. This value goes up to 95% of book value of the claim depending on the level of turnover, balance sheet of the buyer, the risk which the factor undertakes. Having in mind the high value which is paid by the factor, before the assignment of claims, the factor inquires about the credit worthiness of the foreign buyer.

The factor is not obligated to, within the so called “global cession”; take over every claim that is offered to him, especially if the claim seems to be dubious.

In the other variant of “open” factoring the exporter (client) assign the claim to the factor only for the purpose of collection; the cession is not performed in order to definitely transfer the claims to the factor, but only so the factor could collect the claims from foreign buyer in his name, but on behalf of domestic exporter (the client)<sup>25</sup>.

“Undisclosed” factoring is a rather complex legal business where the presence of factor in business is hidden from the third party (therefore undisclosed – hidden factoring); in undisclosed factoring the exporter sells the goods ready for export, for cash. The factor (as hidden principal) resells these goods, on credit, through the exporter, to the foreign buyer. Before the foreign buyer there appears only the client, who is not the owner of goods since it has been sold to the factor. The client appears in his own name and on behalf of the factor (as his commission agent). This rather complicated transaction allows the increase in price (since the



factor's profit and short term credit given to exporter are included in it). With the use of such a complicated transaction the exporter gets cash no matter the goods are being sold on credit. The factor, on the other hand, receives considerably larger commission<sup>26</sup>.

One of the most important divisions of factoring businesses is the one where we can distinguish factoring with the right or without the (factor's) right of recovery. In factoring with the right of recovery, in case of the inability of the factor to collect the claim, he has the right of recovery towards the client, where as in factoring without the right of recovery, in case of the absence of payment, the factor takes over the whole risk of claim collection, naturally it comes with a higher commission<sup>27</sup>.

Factoring can be divided also accordingly to the territorial principle, therefore, naturally we have domestic and international factoring, depending whether the contract between the client and the factor is concluded in the same country or not.

Having in mind the number of subject participants in factoring business it is possible to make a division to direct and indirect factoring, in the latter, having in mind its international character, two factors appear the export and import one; some of divisions mentioned can mutually overlap (for example indirect and international).

## 7. INSTRUMENTS OF CLAIM TRANSFER IN FACTORING

Cession<sup>28</sup> is the usual instrument for assignment of claim in factoring; however it should be emphasized that, when these businesses are in question, in some countries cession of claims is not permitted, therefore instead of it is used personal subrogation<sup>29</sup>.

Cession, that is assignment of claims, is performed on the basis of agreement (contract) between assignor (cedent) and assignee (cessionary) where the consent of the debtor (cessus) is not required<sup>30</sup>.

The condition which inevitably has to be fulfilled in order for cession to be valid is the existence of (some form) of informing the debtor (notification) of the assignment of claim.

In civil law countries the system of notary notification of debtor is a usual practice; unlike continental, the law and practice of anglo-saxon countries, are applying the system of registration of the claims. The application of registration system has dual function, apart from notifying the debtor about the assignment of claim, registration serves also as the mean of security of the factor (since it establishes the priority of collection in his favour<sup>31</sup>).

Besides the differences in systems of informing debtors of performed cession (that is the change of creditor), the differences between the civil law and some common law countries are present as far as the permissibility of contracting the ban on assignment of claims generally is in question.

In countries of continental law, and in England as well contracting the ban on assignment of claims is permissible<sup>32</sup>; impiety of this restriction as a consequence produces invalidity of assigned claims (in that case the cessionary can not collect claims from the debtor). The view of American Uniform Commercial Code (UCC) is completely opposite, in fact, it is absolutely forbidden to contract the ban on assignment of claims. This absolute ban on assignment of



claims

suits strong commercial subjects which appear as buyers in a large number of buying businesses (to take account possible change of creditor would greatly complicate their position).

According to the provisions of the factoring contract (between the client and the factor) the client (seller, performer of services) assigns his future claims (from the contract of sales or performing services, concluded with the buyer of goods or services) to the factor<sup>33</sup>.

Towards the buyer of the goods or services the factor has the position of the creditor from contract from which assigned claim originated. In conformity with the provisions of contract law debtor can post all objections he had related to the factor also to his predecessor.

Significant for factoring business can be the relation of factor towards the third parties that can claim the right to collect from the assignment of claim (especially in case of "global cession"). In connection with possible claims of the third parties, in practice disputable situations can occur, in conformity with legal regulations of contract law in the countries of continental legal tradition the priority in collecting has the creditor which was the first to obtain that right or the one about whom the debtor was first informed. Anglo-saxon countries, that practice the system of registration as the system of informing the debtor, establish the priority in collecting according to the order of (their) register entries.

## 8. NORMATIVE ORGANIZATION OF FACTORING

As a »new« institute established in business practice, factoring was not directly regulated in comparative law practice for a rather long time.

Common law countries and countries of roman legal tradition have somewhat different approach to factoring business. These differences creates certain difficulties in practical application of factoring, but they made also difficulties in normative regulation of some basic questions concerning factoring; naturally the difficulties primarily appear in civil law countries.

Because it is the »product« of anglo-saxon business practice<sup>34</sup> factoring is structured in conformity with the demands of common law system; the specific business concepts are regulated with more pragmatism which is the characteristic of common law legal tradition.

Civil law countries, which based their legal institutes on roman legal tradition, had to adjust the specificities of factoring business with existing rules (of their) civil law. Generally, as the biggest problem of civil law countries in the matter of factoring business and its organization appeared the inability of assignment of future and total claims (so called "global cession").

In view of comparative law the question of cession was not treated equally in all countries with civil law tradition.

In France<sup>35</sup>, in 1981 the law was passed (loi Dailly) which provided simpler assignment of future claims. Provisions of this *lex specialis* had no real effect in practice.

Unlike France (which did not »permit« cession), Belgium made certain changes within its positive law, so in that way it allowed the application of cession.

Italian law had certain problems in the application of factoring, despite that in Italian business practice, factoring operation has been very successfully used; the aforementioned problems were very efficiently overcome by the court practice<sup>36</sup>.



Regarding the system of informing the debtors (without the very same there is no validity of the cession i.e. the transfer of the claim) the system of notary notification was accepted in Italy, however its strictness weakened as the time passed, so the courts were satisfied by "simple" notification of the debtors in written form. The problem of the impossibility of ceding of future claims was resolved by rendering a special law 1991.<sup>37</sup> The transfer of the future claims by means of this Law is limited to those claims which occur within a 24-month period from the day of contract conclusion on factoring.

As well as in other European countries, German business practice was familiar with the institute of factoring; regarding the legal realization of the factoring operation, fairly complicated system was used which was realized through the framework agreement and more agreements on transfer of the claims from the creditors on factors. Owing to the complex contractual structure, there were no big requests (registration, acceptance of the debtors) in the view of the ceding effects towards the third entities.

In the USA, factoring operations was governed by the provisions of UCC (Chapter 9-106) but only after a long time factual application and notable number of the court cases. Factoring is conceived and understood as a means of financing and provision (of payment). The company seller receives from the factor financial assets (financing) and as a security for the received assets it transfers on the factor his (current and future) claims. Here, the sale of (rights) claims is taking place, in order for the sale to make an impact towards the debtor and towards the third entities as well, an American system predicted registration.

The legal system of Great Britain is not too demanding regarding the issue of factoring operation, as for the validity of the contract on factoring a written notification of the debtors is required, although these requests, as well as in some continental countries, are less and less formal, so very often an invoice is presupposed as a valid notification.

Beside mostly sporadic organization of the factoring operation via special laws (France, Italy) or within the existing trading or civil regulations (USA, Belgium) and few countries in transition, rendered the regulations on factoring, and these are Russian Federation (Civil codex, ch.43, articles 824-832) and Moldova (Civil code, art. 1290-1300).

On international plan, up to the rendering of UNIDROIT convention factoring operation was organized only according to the rules of the common law and autonomous trading law. After the conducted procedure of international unification which was carried out under UNIDROIT, 1988 in Ottawa a Convention on international factoring was rendered.<sup>38</sup> Convention came into force in 1995.

Starting from a great number of existing modalities, Convention defined the contract on factoring as the contract on the basis of which the deliverer is obliged to transfer on the factor the existing or the future claims from the contract on the sale of goods i.e. service rendering between the deliverer and his buyer i.e. the user of the services (debtor). There is an assumption that it is the issue on permanent business relations between the contracting parties.

Convention envisaged four basic factors of factoring, these are financing of the deliverer, book keeping, collection of claims, and protection from failure in payment of debtors.

In conformity with the provisions of the Convention, the factor must perform at least two out of four aforementioned functions.

Convention is, as an important condition for existing of the contract on factoring, pointed out the notification of the debtors on the transfer of claims. In conformity with the provisions of the Convention, deliverer will be obliged to submit the notification on the transfer of claims on the factor, but this notification may be delivered by the factor, upon the authorization of the deliverer.<sup>39</sup>

The most important provisions of the Convention deal, of course, with the rights and obligations of the contracting parties. In conformity with the provisions of the Convention the transfer of the existing and future claims is possible, and it is also possible to contract a global cession. Convention has, therefore, accepted the notion of cession as the manner of claims transfer.

One of the significant solutions from the Convention relates to the agreements on the prohibition of the claims transfer from the basic affair (deliverer-buyer); these agreements will be without an impact on the factoring operations. By insight into the provisions of the Convention it is obvious that there is legal autonomy between factoring and the contract on sale, an issue of responsibility from the side of the deliverer towards the debtor regarding the breach of the basic affair, in case of the claims ceding, would not influence the very factoring operation.

Regarding the legal relation between the factor and the debtor in the Convention, the latter has rights to point out all objections (towards the factor) that he might have pointed out and towards the first creditor (deliverer).

When the issue of the legal organizations of the factoring operations in countries under transition is being discussed, it was mentioned that only Russian Federation and Moldova have legal provisions which directly and indirectly refer to factoring, other countries do not have such direct legal regulations since regarding these operations, alongside the provisions of the autonomous right, direct regulations are being applied (mostly these by which banking affairs are being organized).

In the Republic of Serbia there are frequent requests in relation to the normative regulation of the factoring operations, these requests coincided with an initiative for rendering a comprehensive text of the Civil Code.

Factoring has been drafted in the first draft of the Civil Code (CC).<sup>40</sup> Alongside the suggested text, a reserve was stated in the view of the suitability of the legal regulating, this reserve was added since this is the issued of the "new" contract established in the business practice, which was, up to the present moment, regulated by the general conditions on operating of factoring organizations, i.e. by the provisions of » *lex mercatoria* «, and on international plan it is regulated by the provisions of the Convention on international factoring ( rendered in 1988 in Ottawa).

The text of the draft of the CC conceptualized the definition of the factoring operation, and establishes the content of the factoring contract and the its form (obligatory written).

The text of the draft determined the contracting party, claims that are being transferred, stipulation of the moment of claims maturity, manner, time and payment venue, compensation that the factor gets for his services.

The text of the first draft of the CC envisaged that the existing or future claims may be ceded and has precisely determined which moment is considered to be the moment of the cession of the existing<sup>41</sup>, and which moment relates to the future claims<sup>42</sup>.

The offered text of the first draft envisaged the rights of the factor for collection and for bearing of the risk in relation to the collection depending on the type of the factoring operation.

The first draft of the CC envisaged responsibility of the client for the existence of the ceded claim as well as for his collection

Regarding the notification of the clients, the first draft established that the client or a factor are obliged to inform the debtor on the performed cession, if there happens to be an omission in notification of the clients, he will not be obliged to perform the payment to the factor, however his obligation towards the deliverer would remain effective.

Provisions suggested in text of the first draft of CC that relates to the contract on factoring mostly follow the usual business practice and solutions from UNIDROIT Convention on international factoring. Until the definite draft and adoption of the text of the Civil Code, regulations on banking affairs as well as rules on autonomous trading law will be used (general conditions in business, usual contracts, etc.)

## 9. CONCLUSION

Financial means, their lack and the ways how to provide them are biggest problems of business practice. Among many other existing methods of financing, business practice introduced factoring as a special method of financing. The essence of factoring is the assignment of receivables and transfer of risks. Like the other methods factoring also have advantages and disadvantages.

Factoring, as a special technique has some common functions, first and most important of these functions is the function of financing (of the client - the supplier). Other functions of factoring are advance payment, book keeping, regarding claims, collecting of the claims, protection against failures of payment, and all of them are also very important.

Factoring, this special technique of financing is realised in practice by factoring contracts. Factoring contract is a legal transaction (based on the institute of assignment), under which the creditor assigns its receivables to factor-organisations.

Commercial practice has developed numerous forms of factoring agreements. In spite of their diversity, all kind of factoring agreements have certain common characteristics in terms of their subject matter, conclusion, effect, termination, rights and obligations of the contracting parties. etc.

In this article the authors are analyzing the most important characteristics of factoring especially its legal aspect (comparative and international normative regulation, rights and obligations of the parties, types of contracts etc.).

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[www.businesslink.gov.uk/bdotg/action/detail](http://www.businesslink.gov.uk/bdotg/action/detail)

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[www.yellowpages.rs/advokati-finansije/factoring/Srbija](http://www.yellowpages.rs/advokati-finansije/factoring/Srbija)

## ENDNOTES

(Endnotes)

1 See N. Joubert, *The Legal Nature of Factoring Contract*, *The South African Law Journal*, 1987, vol. 104 (part I), p. 88; Klapper, L. 2000. "The Determinants of Global Factoring." In *World Factoring Handbook 2000*. BCR Publishing, Kent, United Kingdom.; Klapper, L., and D. Vittas. 2003. "The Use of Reverse Factoring." World Bank, Washington, D.C.

2 The sources of financing can be, depending on the purpose, divided into long term (capital investments) and short term (financing of commerce among other things). Factoring business represents one of the forms which are often used in short term commerce financing. See more in R. Kovačević, *Important role of factoring as an instrument of financing export-experiences of new members of EU*, *Economic annals*, (April - June) 2005, no. 165, p. 81; Muschella, D. 2003. "The Italian Factoring Industry." Paper presented at the World Bank Conference on the Factoring Industry as a Key Tool for SME Development in EU Accession Countries, 23–24 October, Warsaw, Poland; World Bank (2003), *Czech Republic, Policy Note: Insolvency and Creditor Rights System*, Fourth Draft, October 15, 2003; Worthy, R. G. 2003. "Factoring: Modern American Style." Paper presented at the World Bank Conference on the Factoring Industry as a Key Tool for SME Development in EU Accession Countries, 23–24 October, Warsaw, Poland; Papadimitriou, D. B., R. J. Phillips, and L.R. Wray. 1994. "Community-Based Factoring Companies and Small Business Lending." Working Paper 108. Jerome Levy Economics Institute, Annandale-on-Hudson, NY.

3 See M. Vasiljević, *Trgovinsko pravo*, Beograd, 2006, p. 290.

4 See I. Spasić, M. Todorović, *International financial leasing and International Factoring*, Belgrade, 1989, p. 19. We can find similar definitions of factoring in V. Gorenc, *Factoring cession, Economy and law*, 1982, no. 3, p. 3; S. Carić, *New trends in legal regulations of the trading of goods*, Novi Sad, 1976, p. 3; B. Pavićević, *Contracts on leasing, franchising, factoring and forfeiting*, Belgrade, 1992, pg. 45; M. Todorović, *Factoring contract*, master thesis, Law school Belgrade, 1979, p. 14; M. Vasiljević, op.cit. p. 290; R. Đurović, *International commercial law*, Belgrade 1977, p. 418; J. Vilus-S. Carić-S. Šogorov, *International commercial law*; Belgrade, 1989, p. 430;

5 See Internet page <http://contracts.onecle.com/bam/cbcc.factor>

6 About differences and similarities of factoring and other contracts see more in N: Joubert, op. cit. p. 90 – 100, Berger A. and I. Hassan, 2004, „Further Evidence on the Link between Finance and Growth: An International Analysis of Community Banking and Economic Performance”, *Journal of Financial Services Reserch*, forthcoming.

7 There are concepts of its much older origin (the period of Hammurabi; Roman empire; England 14. century); all these forms can be origins of this business, but they are in fact related to representation or of performance of certain actions on behalf of others, and not to factoring.

See more in R. Kovačević, op. cit. p. 82.

8 In that way the agents took over the business of forwarding, storing, but also the book keeping business, the business of invoice issuance, conducting procedures in connection to debt enforcement (before the court or arbitration).

9 See Ivanka Spasić, *The Role of Assignment in Factoring Contracts*; Foreign Legal Life, 2009, n. 3, p. 132 and further; about the advantages of the factoring see also T. Rajčević; *Factoring, Law and economy*, 2005, n.5-8, p. 425 ad further;

10 See R. Kovačević, op. cit. p. 83;

11 See R. Kovačević, op. cit. p. 91

12 See more about advantages of factoring on Internet pages: <http://www.businesslink.gov.uk/bdotg/action/detail>

13 About more disadvantages see also Internet pages: <http://www.businesslink.gov.uk/bdotg/action/detail>

14 For example in Croatia and Serbia (countries which up to recently did not have remarkable volume of factoring business, nor numerous factoring organizations) nowadays a large number of banking organizations perform also factoring operations (among others for example Croatia bank, Zagrebačka bank, Reiffaisenbank, Erste factoring, Commercial bank Zagreb in Croatia and Societe General Bank, OTP- although bank, AOF agency in Serbia); apart from these banking departments there are also independent factoring organizations, there are fewer (for example D factor in Croatia and Prvi faktor (The First factor), Focus factor, Finebra and Oekb in Serbia) more information on Internet pages [www.wlw.hr/CompaniesByProducts](http://www.wlw.hr/CompaniesByProducts) and [www.yellowpages.rs/advokati-finansije/factoring/Srbija](http://www.yellowpages.rs/advokati-finansije/factoring/Srbija)

15 These international factoring companies are mainly founded by large world banks or the very banks are performing these operations within specialized departments (for example Lloyd 's; Midland Bank, Barclay's etc. have such departments)

16 Factors Chain International; International Factors Group; Credit Factoring International; Walter E.Heller Overseas Corporation. Of these few multinational networks only FCI network (Factor Chain International) is opened and consists of independent national factoring companies, this network has the largest number of members and the largest volume of factoring operations, see more M.Todorovic, op. cit. p. 20 and further.

17 Apart from increased risk of collecting claims, in international transactions also appear the questions of meritory law, unification of standards of material law, possible state measures (mainly of restraining character) etc.

18 See N. Joubert, op. cit, p. 89; Charpentier, D. 2003. "Factoring and Credit Insurance: Competitors or Complements?" Paper presented at theWorld Bank Conference on the Factoring Industry as a Key Tool for SME Development in EU Accession Countries, 23–24 October,Warsaw, Poland; Frank, M. Z., and V. Maksimovic. 2003. "Trade Credit, Collateral, and Adverse Selection." Working paper. University of Maryland Finance Department, College Park, Md.; Jappelli, T., and M. Pagano. 2001. "Information Sharing, Lending and Defaults: Cross-Country Evidence." *Journal of Banking and Finance* 26: 2023–2054.

19 About contemporary trends in the development of factoring see more. R. Kovačević, op.



cit. p. 83; Jimenez, G., and J. Saurina. 2003. "Loan Characteristics and Credit Risk." Paper presented at the Federal Reserve Bank of Chicago Conference on Bank Structure, May; Kallberg, J., and G. F. Udell. 2003a. "Private Information Exchange in the United States." In *Credit Reporting Systems and the International Economy*. M. Miller, ed. Cambridge, Mass.: MIT Press.; Kallberg, J., and G. F. Udell. 2003b. "The Value of Private Sector Business Credit Information Sharing: The US Case." *Journal of Banking and Finance* 27: 449–469.

20 About different functions of factoring and their specifics see more I. Spasić, Factoring and forfeiting contracts, *Legal Life*, no. 11/2010, p. 359-360

21 The duty of informing the debtor about the transfer of claims to the factor is present in all national legal systems, although the forms of informing and the party (in factoring relation) which is obligated to do that may vary.

22 See I. Spasić, op. cit. p. 360

23 See Becker, *Bank Betriebslehre*, Kill, 1977, p. 132; the same B. Pavićević, op. cit, p. 52; Bakker, M., and A. Gross. 2004. "Development of Non-Bank Financial Institutions and Capital Markets in European Union Accession Countries,," Working Paper No. 28. World Bank, Washington D.C; Berger, A. N., N. Miller, M. Petersen, R. Rajan, and J. Stein. 2002. "Does Function Follow Organizational Form? Evidence from the Lending Practices of Large and Small Banks." Harvard Institute Research Working Paper, Boston; Kaufmann, D., A. Kraay, and M. Mastruzzi. 2003. "Governance Matters III: Governance Indicators for 1996–2002." World Bank Policy Research Working Paper.

24 See B. Pavićević, op. cit. p. 50-51.

25 The role of the factor here is similar to the role of commission agent (factoring business originated from commission business); see B. Pavićević, op. cit. p. 51.

26 See B. Pavićević, op. cit. p. 51-52

27 See N. Joubert, op. cit. p. 91.

28 Factoring contract should not be identified with the cession.

29 In France the cession of claims is not permitted in accordance with general rules of contract law

30 In previously mentioned France, in order to perform valid assignment of claims, it is necessary not only to notary inform the debtor, but for him to agree to it; in large number of cases this makes it harder, even impossible to assign claims so for the purpose of factoring another institute is used and that is personal subrogation.

31 About the specifics of American system of registration and its important differences in regard to the notification system see more in T. Milenković-Kerković, The change of subject in contract and the needs of regulating factoring contracts by law, *Law and economy*, no, 5-8, 2006., p. 466.

32 English Law on Property Act from 1925, Italian Codice civile, par. 1260, Swiss law on contracts Art. 164 pg.1 etc.

33 If the due claims are in question there is no credit function in factoring, but only the service of collecting on other's behalf (in their name and on behalf of others).

34 Factoring originated in common law countries, on the basis of the institute of assignment

- 35 One of the key problems of French law was the inability to use cession, and naturally for that matter the global cession as well.
- 36 See T. Milenković-Kerković, op. cit. p. 469
- 37 Legge del 21 febbraio 1991, n. 52 sulla disciplina della cessione dei crediti d'impresa.
- 38 Even from the title it can be seen that Convention relates only to the international operations of factoring.
- 39 Provisions of the Convention will not relate to the non-factoring, which is actually a banking credit (discount claim) where the claim is used as a mean of security, see Spasic, I., Todorovic, M., op.cit. p.30
- 40 The text of the first draft of CC has been published in the publication Civil Code of the Republic of Serbia (first draft), second book, Contractual relations, Belgrade, 2009.
- 41 Moment of conclusion of the contract on factoring.
- 42 Moment of cession of the future claims is considered the moment of their origination, if it is not stipulated otherwise by the contract.

## FAKTORING – INSTRUMENT FINANCIRANJA U POSLOVNOJ PRAKSI – NEKOLIKO VAŽNIH PRAVNIH ASPEKATA

### Sažetak

*Uspješna poslovna praksa treba stalne izvore financijskih sredstava. Jedan od najvećih problema poslovne prakse je kako osigurati ta sredstva. Osim mnogih drugih metoda, u poslovnoj se praksi često koristi faktoring kao metoda financiranja. Faktoring se, kao posebna metoda financiranja, u praksi realizira putem ugovora o faktoringu.*

*Ugovor o faktoringu je pravna transakcija zasnovana na instituciji doznake putem koje kreditor faktoru (uglavnom specijaliziranim tvrtkama) doznačuje tražbinu.*

*Faktoring ima nekoliko uobičajenih funkcija od kojih je prva i najvažnija financiranje (dobavljača). Ostale funkcije faktoringa poput plaćanja unaprijed, knjigovodstva, ustanovljavanja potraživanja, naplate potraživanja, zaštite od neizvršene naplate, su također vrlo važne.*

*Trgovinska praksa je razvila brojne oblike ugovora o faktoringu. Usprkos njihovoj raznolikosti, sve vrste ugovora o faktoringu imaju neke zajedničke karakteristike u smislu predmeta, zaključka, učinka, raskida itd.*

*Ugovori o faktoringu nisu u potpunosti obuhvaćeni postojećim zakonskim propisima ali su regulirani UNIDROIT Konvencijom o međunarodnom faktoringu. U ovom članku autori analiziraju karakteristike faktoringa i ugovora o faktoringu.*

**Ključne riječi:** *faktoring, ugovor o faktoringu, dodjela kratkoročnih potraživanja.*