

Factoring financing under Chinese laws

Description

One of my clients, a bank, has approached me for advice on a dispute involving factoring financing with a trade company in Shanghai. It is a domestic factoring dispute. The amount of money involved is huge and I devoted a great deal of time to make sure that sound legal advice is given.

Factoring is relatively new in China. The industry has just witnessed a rapid growth in the past a couple of years. Unlike in the west where commercial factors taking up a big share in this industry, factors in China are mostly banks. It is reasonably to assert that factoring is an imported financial instrument from the west where factoring can track back a century ago.

As it is new in China, many people including those working in factoring industry may not really know what factoring is. At least, the people at the bank (my client) were not really knowing what they are doing. It was the first factoring deal they did in China. The documents for the deal were copied from other banks. As in the commercial practice, courts in China don't have a clear idea about factoring. There are very few publicly available precedent cases and very few articles discussing factoring from judicial perspective.

I would attempt here to explain the recourse factoring prevalent in China under Chinese laws.

1. Typical Factoring Arrangement in China

While in the west, factoring takes its form initially without an advance or prepayment of the purchase price by the factor, it is however imported into China almost solely for purpose of financing, arranged between suppliers or sellers and banks in China. So far the cases I personally learned are all involving a loan from the bank to the supplier. The other functions of factoring as set out in UNIDROIT Convention on International Factoring such as account ledgering, collection, and credit protection are absent at large.

Typically, the supplier approaches a bank to assign its existing account receivables in exchange for a loan extended by the bank. The bank may or may not charge interest on the loan. To protect the repayment by the supplier of the loan, the bank will ask the supplier to provide or procure the provision of security (mainly personal guarantee from suppliers's shareholders), and also as a normal arrangement in recourse factoring, the bank will have the right to sell back the purchased accounts to the supplier in the event that the receivables are not received as agreed or a dispute under the supply contract is raised by the account debtor.

In practice, non-recourse factoring is rare in China and most bank factors only conduct recourse factoring mainly for the reason that credit risks in Chinese market are much higher. Don't forget that even today, personal relationships (rather than objective credit appraising) still play a substantial role in businesses doing in China.

2. Nature of Factoring, True Sale or Not

Interestingly enough, factoring, originating from the west, still finds itself caught swirling in legal battle in court rooms today. Many legal practitioners and scholars, esp in USA, just cannot concur on the question: whether recourse factoring with advance is a true sale or secured loan. American judges may readily recharacterize an explicitly expressed sale of receivables as a secured loan. Somehow, it seems that in UK (other jurisdictions patterned on it like Hong Kong), there is an obvious tendency in courts to recognize that recourse factoring should still be regarded as a true sale deal instead of secured loan.

In China, there is no legal soil to breed that debate. As a civil law country, China does not have any form of security interests involving the transfer of ownership of collateral. It is just not possible for any China court to find a valid secured loan deal out of a factoring arrangement. So by contrast, it is almost an established view in China legal field that a factoring deal is in essence an assignment of contractual rights and therefore falls within the ambit of the rules in China Contract Law that govern the assignment of contractual rights as prescribed in Section 79 to Section 83.

“Assignment” and “sale” are interchangeably used in Chinese laws. Strictly speaking, under China Contract Law, a sale contract is specifically defined as a contract for transfer of ownership of “goods” in consideration for money price. In other words, rules about sale contract under Chinese contract law may not all be applicable to the assignment of receivables. After all, an account receivable is a right in personam and ownership in goods is a right in res (rem), and there are some fundamental differences between them.

Here is the translation of Section 79-83 in China Contract Law for reference. Please note, this translation is quoted from Internet and is not the work of this blogger, Jason Tian.

Article 79 Assignment of Rights; Exceptions

The obligee may assign its rights under a contract in whole or in part to a third person, except where such assignment is prohibited:

- (i) in light of the nature of the contract;
- (ii) by agreement between the parties;
- (iii) by law.

Article 80 Duty to Notify When Assigning Rights; Revocation of Assignment Subject to Assignee's Consent

Where the obligee assigns its rights, it shall notify the obligor. Such assignment is not binding upon the obligor if notice was not given.

A notice of assignment of rights given by the obligee may not be revoked, except with the consent of the assignee.

Article 81 Assumption of Incidental Right in Case of Assignment

Where the obligee assigns a right, the assignee shall assume any incidental right associated with the obligee's right, except where such incidental right is exclusively personal to the obligee.

Article 82 Assigned Rights Subject to Accrued Defenses of Obligor

Upon receipt of the notice of assignment of the obligee's right, the obligor may, in respect of the assignee, avail itself of any defense it has against the assignor.

Article 83 Availability of Set-off to Obligor

Upon receipt of the notice of assignment of the obligee's right, if the obligor has any right to performance by the assignor which is due before or at the same time as the assigned obligee's right, the obligor may avail itself of any set-off against the assignee.

Despite the mainstream view, there are tensions between the rules above and the normal practice of factoring, leaving some uncertainty of the future of factoring development in China. I will discuss the specific issues of these tensions in later posts.

3. My Understanding of Financing Factoring under Chinese Laws

Recourse factoring with a loan from factor to seller of account receivables is susceptible to recharacterization as a secured loan. Even under Chinese laws, it is quite abnormal to recognize a sale taken the form as shown in the factoring arrangement. In practice, lawyers representing the seller of account receivables contended that the repurchase by or chargeback to the seller of the unpaid accounts is not legal under Chinese laws, making the original sale from seller to factor not qualified as a true sale or assignment of receivables under Chinese laws. In light of peculiar way of payment of purchase price of account receivables by factors, it is not unreasonable to have doubt over the sale nature of transfer of the account receivables.

As noted above, under current Chinese laws, if Chinese courts are not willing to recognize the sale nature of assignment of accounts receivables in factoring, there are no other legal systems that could embrace factoring legally under Chinese laws. Probably the only thing the courts can do is to annul the factoring deal in totality. However this drastic approach will have far-reaching adverse effects on Chinese overall economy and China's integration with the world. That is definitely too much for Chinese courts to do.

So the rest for China's courts is to find ways or doctrines that can logically and legally explain the financing factoring with recourse.

As a contract, the validity of factoring agreement shall be scrutinized in accordance with the rules regarding legality of contracts under China Contract Law. Examined pursuant to China Contract Law, there are really no points in factoring deal that fall into the defined circumstances where a contract is

regarded as void.

Given the legality of financing factoring agreement with recourse, Chinese courts may look at it as follows: it is a structured deal encompassing separate but related legal relationships of sale and lending. The assignment of account receivables from supplier to factor is a sale for consideration of both the “purchase price” to be paid by factor at scheduled time and an extension of specified loan (or we can term it as “lending service”); the loan is a separate deal from the sale but related thereto, as the amount of loan proceeds bears a clear link to the amount of purchase price and the time of repayment of loan by supplier bears clear relationship to the time of maturing of the account debts; in this way, at the certain time, the obligation of factor to pay the purchase price to supplier and the obligation of supplier to repay the loan to factor can be set off against each other; the repurchase or chargeback of unpaid account debts can be seen as normal recourse in a sale of goods whereby the buyer finds such a serious defect in the goods that he is entitled to return the goods to and ask back the relevant purchase price from the seller.

Your comments are welcome. You can contact the blogger here for further discussion on the topic.

Date Created

February 2014

Author

admin

Shanghai Landing Law Offices