The Benefits of Debt Factoring

In light of the continuing growth of the Middle East as a business hub, and particularly the UAE, Paul Afif and Rohat Jumani highlight the benefits of factoring arrangements as well as the legal position as per the UAE Law.

Factoring, which is a common practice in western economies including the UK, USA and Canada is largely an unknown concept in the Middle East. Most businesses in the Middle East rely on customary Documentary Credit or Letter of Credit terms.

Whilst banks and other independent firms provide factoring services in this region, businesses are often unaware of the open account trading terms such as factoring.

FACTORING – WHAT DOES IT MEAN & ITS BENEFITS?

A factoring transaction is an agreement made between a business/creditor and third party such as bank or factoring company, to sell accounts receivable (i.e outstanding invoices) at a discounted rate in return for an immediate cash flow injection .

The customer/debtor is also part of the agreement. However their terms of payment do not change except that the money is now owed to a different company. Normally, the viability of these factoring agreements rely on the credit records of the customers.

Factoring is a method by which businesses may have prompt access to additional cash. It is beneficial when the cash flow is inadequate to meet the existing financial obligations.

TYPES OF FACTORING

General Invoices Factoring

This is between factoring firm, the invoicing business and debtor.

Reverse Factoring

In reverse factoring, there are three parties involved: factoring firm, the invoicing business and individual customers that have to pay the outstanding invoices.

Reverse factoring is initiated by the debtor to help finance receivables at lower rate than the business would normally be offered. Since the process is initiated by the debtor, it is the debtor which is liable to pay the factor. The factor would not normally be allowed to bring legal proceedings against the business if the debtor defaults on payments.

FACTORING AS GOVERNED BY THE UAE LAW:

Factoring is considered an "assignment of debt" in the UAE. It is dealt with under the provisions of Federal Law No. 5 1985, the Civil Transactions Law ("Civil Code").

By virtue of Article 1106 of the Civil Code, an assignment is the transfer of a debt.

Article 1109(1) requires the consent of the parties for an assignment to be valid. It states that:

"In order for an assignment to be valid, there must be consent of transferor and the transferee, and the creditor."

Consent is therefore a fundamental requirement for the legitimacy of a factoring arrangement in the UAE. However, a tripartite agreement is not required and notification to the debtor shall suffice if the initial contract permits the creditor to sell the debt to the factor, if the creditor wishes to do so.

In contrast, under English common law the position was that the assignment would be invalid if the debtor is not notified about the assignment. However, the practice is now different in the UK. Where factoring is a confidential activity and the debtor is not informed about it, the seller continues to collect the dues on behalf of the factor.

IS FACTORING A LEGITIMATE ACTIVITY FOR ANY COMPANY?

Assignment of debt in the UAE is not considered as a banking activity and Central Bank regulations do not apply.

Usually banking activities are only carried out by a Public Joint Stock Company ("PJSC"). However, since factoring is not a banking activity, it can be carried out by a company with a General Trading License.

WHAT REQUIREMENTS AND RESTRICTIONS IN RELATION TO FACTORING WILL APPLY TO COMPANIES?

As per the Article 1113 of the Civil Code, in addition to the general conditions, the following requirements must also be satisfied for an assignment to be valid:

(a) it must be completed and dependent on no condition other than an appropriate or customary condition, nor must any future contract be dependent on it;
(b) the performance thereof must not be deferred to an unknown future date;

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(c) there must be a specific time limit;
(d) the property transferred must be a known debt which is capable of being satisfied;
(e) the property transferred to the transferee in a restricted transfer must be a debt or specific property which cannot be compounded, and both types of property must be equal in type, amount and description; and
(f) it must not involve any conditional or substantial additional consideration in favour of any of the parties, and the assignment shall be unaffected by such additional consideration agreed upon after the assignment was made, and it shall not be payable.

If any of the above conditions is not satisfied, as assignment shall be void further to Article 1114.

Factoring is useful practice when the profit on initial costs borne by the creditor is higher than the costs involved in factoring the receivables. The difference between the profits and the costs involved in factoring is therefore vital in deciding if factoring is beneficial for a business or not.

In light of the above discussion, factoring is a beneficial activity which is carried out by most business sectors including retail, manufacturing, transportation, services, distribution, construction etc. However, it is very important to comply with legal technicalities, which are involved at the time of drafting the factoring agreements in order for an assignment to be valid in the UAE.

This content of this article provides general guidelines about factoring. Specialist legal advice should be sought for individual circumstances.

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