

# Albanian legal framework on Factoring contract

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## Abstract

Factoring contract is a new phenomenon, compared to earlier forms of commerce in juridical circulation.

Factoring is a method used by a firm to obtain cash when available cash balance, held by the firm, is insufficient to meet current obligations, and accommodate its other cash needs, such as new orders or contracts. The use of factoring to obtain the cash, needed to accommodate the firm's immediate cash needs, will allow the firm to maintain a smaller ongoing cash balance. By reducing the size of its cash balances, more money becomes available for investment in the firm's growth. A company sells its invoices at discount to their face value when it calculates that it will be better off proceeding to bolster its own growth than it would be by effectively functioning as its "customer's bank".

Many businesses have cash flow that varies. A business might have a relatively large cash flow in one period, as well as a relatively small cash flow in another period. Because of this, firms find it necessary to both keep a cash balance on hand, and use such methods as factoring, in order to enable them to cover their short term cash needs in those periods in which these needs exceed cash flow.

**Keywords:** contract; factoring; factor; debtor

## Introduction

A factoring contract is one through which an entrepreneur, named transferor, commits the transfer of all the present and future credits deriving from its activity to a specialized, professional entity, named factor, who, as concerns the payment of a compensation, is obliged to offer a series of services including accounting, management, collection of all or part of credits that it has in relation to the activities, to insure the eventual failure of debtors, or financing of concerned contractors, through the provision of loans, or through the payment of transferred credits.

Under the factoring contract, the supplier is obliged to submit the contracts stipulated, or to be stipulated with the client, to the factor, which has the right to approve them after having evaluated the solvency of clients and the credits arising from these contracts.

The supplier is also obliged to transfer the loans approved by him to the factor, which is obliged to give the suppliers, within the expiration date, the compensation of the transfer for which they have agreed. The factor buys the loan and collects it from the solvable debtor as his own credit.

### **A short history of the factoring contract**

It is believed that the factoring contract was developed in the United States of America 100 years ago. Some researchers define the sixteenth century as the period during which this contract was born in Great Britain. Because of the then slow communications and transport, for the sale of products in another territory, it was necessary to assign an agent in that territory, and charge him or her with the duty of finding purchasers to sell and ship goods on behalf of principal.

The factoring origins lie in financing trade, particularly international trade. Factoring, as a fact of business life, was underway in England prior to the year 1400. It appears to be closely related to early merchant banking activities. The latter, however, evolved by extension to non-trade related financing, such as sovereign debt. Like all financial instruments, factoring evolved in the course of centuries. This was driven by changes occurring in the organization of companies, technology, particularly in air travel and non-face-to-face communications technologies, starting with telegraph, followed by telephone, and then by computers. These also caused and resulted from the modifications of the common law framework in England and the United States.

Originally, the industry took physical possession of goods, provided cash advances to producers, financed credits extended to buyers, and insured the credit strength of buyers.

Nowadays, the factoring's rationale still includes the financial task of advancing funds to smaller, rapidly growing firms that sell to larger, and credit worthier organizations. While almost never taking possession of the goods sold, factors offer various combinations of money and supportive services when advancing funds.

The financial transaction, or the arrangement through which a company sells its invoiced debts to a third party, at discount in exchange for immediate cash to finance continued business, is called Factoring.

### **Characteristics of the factoring contract**

The factoring is a financial alternative for the management of income, namely, a transformation of the credit price in cash. The financial institute, called the factor, buys the accounts of the income of a commercial company familiar with the term customer, and pays immediately up to 80 percent of the amount agreed upon. The factoring

company, which realizes the factoring, pays the remaining amount to the client when the customer pays the debit against the supplier. The collection of debts from the customer can be conducted by the factor himself, or by the client, in compliance with the type of the factoring contract.

Thus, the factoring is the sale and purchase of debts, usually performed by a company; it is a method, by means of which, a business can raise money to increase the monetary situation, in order to finance its expansion and continued development. The factoring is the only method of financing, which immediately leads to the further development of the commercial activity of the company, the decrement of the prices included.

The factoring contract is a contract under compensation, where compensation is paid for the service of the management of loans, as well as a guarantee against the risk of insolvency of the debtor.

The factoring contract is a consensual contract under compensation to which the participating parties are the factor, the supplier, and the debtor. As regards form<sup>1</sup>, our legislation defines this contract as a formal contract for demonstration effects, a contract, which must be stipulated in writing between the supplier and the factor, and can be with a definite term or not<sup>2</sup>. If there is a term, it ends upon the conclusion of the relevant stipulated deadline. In the case of a long-term contract, the latter terminates after the repayment of all the credits of the customer's account, transferred through this contract.

Our legislation foresees that the object of the factoring contract are the existing loans and / or the future credits of the client's account, which arose, and / or will arise, from the sale of items and / or services by the supplier to the customer. Proceeding from this prediction, it is worth noting a statutory exception related to the sale of items and / or services purchased for personal, family or household use. The transferable loans can be domestic loans, as well as international loans.

Another particularity regarding the object of the contract in question is that the credits of the customer's account can be transferred even before the stipulation of the contracts from which they stem, but the transfer of credits arising from contracts not yet signed should be stipulated within 24 months from the date of signing the factoring contract.

As concerns different kinds of the factoring contracts, Law Number 9630, dated October 30, 2006, defines the following three types:

- Domestic, export or import factoring;

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<sup>1</sup> Article 2: Law "On Factoring" Number 9630, dated October 10, 2006.

<sup>2</sup> Article 7: Law "On Factoring" Number 9630, dated October 10, 2006.

- Factoring without warranty, where the supplier does not guarantee the factor about the debtor's solvency capacities;
- Factoring with warranty, where the supplier completely guarantees the factor about the payment of the credit of the customer's account from the debtor.

In the case of factoring without warranty, however, the supplier shall remain liable and obliged to the factor, if the debtor fails to pay completely the credit of the customer's account, for any reason other than solvency.

Usually, the factoring contract contains also the condition of exclusivity, which, within the duration of the contract, obliges the supplier not to enter into factoring contracts with any other factor.<sup>3</sup> This provision aims to avoid unequal distribution of loans, subject to assignment, as well as the elimination of confusion or interference in the administrative relations between the parties concerned.

### **Entities, which are parties to the contract**

The three parties directly involved are: (1) the one who sells the receivable; (2) the debtor<sup>4</sup>; and (3) the factor. The receivable is essentially a financial asset associated with the debtor's liability to pay money owed to the seller. The seller then sells one or more of its invoices (the receivables) at discount to the third party, the specialized financial organization (the factor), to obtain cash. The sale of the receivables essentially transfers their ownership to the factor, indicating that the factor obtains all of the rights and risks associated with the receivables.<sup>5</sup>

Accordingly, the factor obtains the right to receive the payments made by the debtor for the invoice amount, and must bear the loss if the debtor does not pay the invoice amount.

A "factor" is called a person who buys a debt, which belongs to someone else, with a reduction in price, in order to gain a profit from his collection. The term "factor" in English refers to a person who performs a service for another person under compensation, while the term "factoring" characterizes the sales system of financing.

According to our legislation, the activity of factoring can be carried out only by a series of entities, which are:

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<sup>3</sup> "Il factoring. Aspetti economici, finanziari e giuridici", G. Fossati e A. Porro, Milano, 1994, p. 14.

<sup>4</sup> The three participating subjects (transferor, factor and debtor) stipulate bilateral agreements between them: by one side supplier – debtor, an agreement independent from the factoring contract, and even stipulated before it, and from the other side the agreement factor-debtor. "I contratti moderni: Factoring, franchising, leasing", Mauro Bussani, Torino, UTET, 2004, p. 67.

<sup>5</sup> The factor purchases the credit collects it from the solvable debtor as it is his own credit. "E drejta e detyrimeve, II", A. Nuni, I. Mustafaj, A. Vokshi, Tiranë, 2008, p. 53.

- The banks<sup>6</sup> and non-bank financial institutions, established under legislation in force, operating in the Republic of Albania;
- The commercial companies, which are subject to factoring operations, upon the condition of possessing a capital of not lower than 20 000000 (twenty million) LEKË that should be settled in cash contributions, at least up to the amount of 20 000000 (twenty million) LEKË. The object of such a company cannot be other than the activity of factoring.

Within the context of commercial transactions, a factor takes possession of the goods of someone else, and usually sells them, acting in its own name.

A factor is a company that provides factoring services, and holds the appropriate license, which certifies and skills to conduct such an activity in accordance with the requirements of the law.<sup>7</sup>

A factor is a legal person, who, under our laws, performs at least two of the following: (1) finances the provider, prepayments included, maintains accounts related to the customer's account credits; collects the credits of the customer's account, protects the supplier from the debtors' insolvency resulting from their financial inability to pay. The actions are performed against a fee, which can be a fixed amount and / or an interest rate, for a period of time determined through an agreement between the parties. The factor's overall profit is the difference between the price it has paid for the invoice and the money received from the debtor, excluding the amount lost due to non-payment.

Among the other obligations, we can mention the obligation to notify the debtor. The debtor must be notified of the existence of the factoring contract by the factor or the supplier. His notification is considered as valid if done in writing, including fax, e-mail messages and any other means of communication, which can be reproduced. The written notification shall be considered complete if it has been received by the debtor.

This notification must be carried out within the time specified in the contract, and shall contain the declaration of the existence of the factoring contract, signed between the factor and the suppliers, as well as the identification of the factor and credit of the client's account, subject to the factoring contract.

The supplier is an entity who, on one side, conducts trading activity by providing the debtor with objects and / or services, and on the other side, receives the services offered by the factor, against a precise compensation for a period specified in the agreement between them.

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<sup>6</sup> If the factoring activity is exercised by the banks, then this activity shall be supervised and disciplined by the Bank of Albania. Article 32: Law "On Factoring" Number 9630, dated October 10, 2006.

<sup>7</sup> "Kontratrat civile jotipike", Jani Vasili, Tiranë, 2009, p. 47.

The supplier responds to the factor for the existence and validity of credits of the client's account, and the fact that such loans are transferred to the factor, free of any liens, dispute, objection, claim or any other right of third parties.

From the time when the factor's rights, which stem from the factoring contract, arise, the supplier shall make available to the factor all the documents and data proving the existence<sup>8</sup> of the credit of the customer's account, subject to the factoring contract.

Another obligation on the part of the supplier relates to the case where the debtor, though notified about the existence of the factoring contract, performs the settlement of payment, be it by mistake or otherwise, in favour of the supplier. Thus, the latter is obliged to transfer these funds immediately in favour of the factor. Meanwhile, the debtor means the entity, which conducts commercial activity, and is established in accordance with the law of the country of origin. The debtor is the entity, which purchases items and / or services from the supplier.

The debtor has the right to be notified of the factoring contract, the credits of the customer's account, the object of the contract, and the identity of factor. It should also be mentioned that the rights and obligations defined for the debtor in the contract between him and the suppliers remain unchanged despite the change of the party in whose favour the debtor executes the credit.

In addition to these rights, the debtor becomes subject to a number of derived obligations. Thus, he is obliged to pay the factor, only if it is not aware of the advantages of a different entity to be paid, and if the written notification concerning the transfer of the credit:

- Has been given to the debtor by the supplier or factor, with the approval of the supplier;
- Identifies, in a reasonable manner, the credits of the customer's account, transferred in favour of the factor, against which the debtor must repay the credit;
- Refers to the credits of the customer's account, which have emerged from a sale contract of objects and / or services, stipulated before or at the time of the notification.

The debtor shall not be discharged from liability when he carries out the payment of the credit in favour of the factor, in accordance with these legal provisions, and in any other case, when performing the credit payment by the debtor, in favour of the factor, relieves the debtor from liability. Once the debtor is given proper notice, he pays the factor, under the terms of the contract signed between the supplier and the debtor.

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<sup>8</sup> It should also present the list with the data of the customers, reflecting the characteristics of each of them, their behaviour in the past and the foreseen one, so that the factor can better evaluate the solvency, the characteristics of the credits and the eventual risks. "I contratti moderni: Factoring, franchising, leasing", Mauro Bussani, Torino, UTET, 2004, p. 68.

### **Motives of application of the factoring contract: Its advantages and disadvantages**

The factoring is a form of financing in the case where a company sells its invoices at discount to their face value when it calculates that it will be better off using the proceeds to bolster its own growth than it would be by effectively functioning as its “customer’s bank.”

Accordingly, factoring occurs when the rate of return on the proceeds invested in production exceed the costs associated with factoring the receivables. Therefore, the trade off between the return, which the firm earns on investment in production, and the cost of utilizing a factor are crucial in determining both the extent of factoring used and the quantity of cash, which the firm holds on hand.

Many businesses have cash flow that varies. A business might have a relatively large cash flow in one period, and might have a relatively small cash flow in another period. Because of this, firms find it necessary to both maintain a cash balance on hand, and use such methods as factoring, in order to enable them to cover their short term cash needs in those periods in which these needs exceed their cash flow. Each business must then decide how much it wants to depend on factoring to cover short falls in cash, and how large a cash balance it wants to maintain in order to ensure that it has enough cash on hand during periods of low cash flow.

Generally, the variability in the cash flow will determine the size of the cash balance, which a business will tend to hold, as well as the extent it may have to depend on such financial mechanisms as factoring. Cash flow variability is directly related to two factors:

- The extent to which cash flow can change,
- The length of time during which cash flow can remain at a below average level.

If cash flow can decrease drastically, the business will find out that it needs large amounts of cash either from existing cash balances or from a factor to cover its obligations during this period. Likewise, the longer a relatively low cash flow can last, the more cash is needed from another source (cash balances or a factor) to cover its obligations during this time. As indicated, the business must balance the opportunity cost of losing a return on the cash that it could otherwise invest, against the costs associated with the use of factoring.

The cash balance, which a business holds, is essentially a demand for transactions money. As stated, the size of the cash balance, which the firm decides to hold, is directly related to its unwillingness to pay the costs necessary to use a factor to finance its short-term cash needs. The problem faced by the business in deciding the size of the cash balance, which it wants to maintain on hand, is similar to the decision that it faces when it decides how much physical inventory it should maintain. In this situation, the

business must balance the cost of obtaining cash proceeds from a factor against the opportunity cost of the losing the rate of return, which it earns on investment within its business.

**Among the main advantages of the application of the factoring contract, we can mention:**

The implementation of the factoring contract could bring a range of advantages to the supplier companies, advantages, which relate mostly to administrative and accounting functions, the organization of the enterprise, business strategy, etc.

- Prompt payment of income: A company, which chooses the factoring as an alternative financing, must transfer to the factoring company their incomes derived from invoices for products or services offered to a third party in exchange for immediate payment of their amount to the factor, minus a reduction defined in the agreement.
- The factors make funds available: Even when banks would not do so, because the factors focus first on the credit worthiness of the debtor, the party who is obligated to pay the invoices for goods or services delivered by the seller. In contrast, the fundamental emphasis in the case of a bank lending relationship falls on the creditworthiness of the borrower, and not on that of its customers. While bank lending is cheaper than factoring, the key terms and conditions, under which the small firm must operate, differ significantly.
- Protection against risk: In general, factoring means a sale of income where the risk of making payments by debtors is fully transferred to the factor. The factor has not the customer's support in case of failure of payment by the debtors.
- No insurance required: Because the factoring is essentially a transfer of income, with the factor taking all income together with the rights and remedies of the customer related to specific incomes, generally, other insurance means are not required by the customer.
- The amount in cash, which is benefited, helps businesses to further develop and expand. The amount in cash can help to pay suppliers early on, helping to negotiate sales and having a greater credibility than before. Through the amounts benefited from the factoring, the businesses can conduct various commercial operations in order to have profits. The business has the opportunity to choose the amount required to borrow, and the amount available to borrow will increase with increase of the turnover.
- It is created the possibility to pay back the credits, which have exceeded their terms or those loans that have higher interest costs and fees.
- Signing towards the factoring of the late bills allows businesses to avoid the difficulty of collecting payments.



- Differently from the case of banks, the risk is reduced by the facility of withdrawing only with a short notice.

As with any technique, factoring solves some problems, but not all of them. Businesses with a small spread between the revenue from a sale and the cost of a sale, should limit their use of factoring to sales above their breakeven sales level where the revenue less the direct cost of the sale plus the cost of factoring is positive.

### **Disadvantages deriving for the owners of the business**

The most important risks of a factor are:

- Legal, compliance and tax risks: large number of applicable laws and regulations in different countries.
- High costs: The interest rates applied are higher than that of the traditional commercial loan.
- Operational risks, such as contractual disputes.
- External fraud by clients: Fake invoicing, miss-directed payments, pre-invoicing, not assigned credit notes, etc. A fraud insurance policy and subjecting the client to audit could limit the risks.
- Counter party credit risk related to clients and risk covered debtors: Risk covered debtors can be reinsured, which limits the risks of a factor. Trade receivables are a fairly low risk asset due to their short duration.

### **International factoring**

In cases in which the supplier and the debtor are in the same state, the contract between the supplier and the factoring company is named domestic factoring, and it is called international factoring when the report from which the credit rights derive are concluded between entities located in different states.<sup>9</sup>

The most common form of international factoring is the so called “Two factor system” which differs from domestic factoring, because the participating parties are three: (1) the factor; (2) the supplier; and (3) the debtor. In the international one, the entities of the contract are four: (1) the supplier; (2) the factoring company of the same country, called the export factor; (3) the factoring company of the importing country, called the import factor; and (4) the debtor (importer).

The supplier, who has a credit right as a result of supplies carried on in goods and services in favour of a foreign entity, stipulates a factoring contract with the export factor who, on his part, transfers the credit to the factoring company to the country where the debtor resides, which would require the repayment of the loans.

<sup>9</sup> “Il factoring nella prospettiva europea ed internazionale”, A. Frignani, Roma, 2002.

The export factor stipulates a factoring contract with the transferor and allows the payment of the loans purchased, while the import factor, after he has approved the loans, manages and collects the debts.

Upon the completion of payment, the import factor transfers the amount to the export factor who, on his part, credits this amount in an account in the name of the supplier.

The relations between the two factors are provided for by the so-called "Interfactors Agreements", through which, the companies are obliged to transfer reciprocally all the credits arising from the supplies made by the exporter of the country where they operate. These agreements also provide for the modalities of payments, the criteria for the cost sharing, and the modalities for the settlement of disputes.

## Conclusions

Nowadays, due to the current market constraints, the factoring can be a very good option for all the commercial companies customers of the factoring service, especially for those businesses that have considerable amounts to collect from the invoices issued to their customers while carrying out their commercial activity.

It should be admitted that the factoring is one of the methods of financing companies, which remains necessary and useful for those companies that lack liquidities.

The factoring, however, can be very helpful for small commercial companies that have a small active capital.

In both the theoretical and practical Albanian environment, the treatment of the factoring contract has not found the right place because there are only a few cases of judicial practice, which can enable the consolidation of the position of this contract in the Albanian juridical theory.

The factoring contract is a type of contract still new to our country, which is considered as an innovation in the field of financial instruments available to commercial companies operating in the Albanian market. Thus, the method of financing through factoring has become a popular method of financing, providing assistance to all businesses for improving cash liquidities.

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