

THE ECONOMIC NATURE OF FACTORING AND ITS LEGAL MANIFESTATION ACCORDING TO THE BULGARIAN LEGISLATION AND THE CONVENTION ON INTERNATIONAL FACTORING

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1. The economic development of Bulgaria, its accession to the European Common Market, and the global economy have resulted in the adoption of new forms of economic collaboration which require legal interpretation. The Bulgarian system of laws has expanded to include legal phenomena that it has been unfamiliar with. These phenomena are well-established and applied in international trade relations because they offer rational solutions to issues related to the free movement of goods, services and capital.

The most common among the modern legal instruments are leasing, franchising and factoring. Of these, factoring is the least known in Bulgaria. However, it has the same practical significance as the other two legal phenomena for economic activities, especially these of the small and medium-sized entrepreneurs.

The objective of this paper is to outline the economic nature of factoring and its legal manifestation.

2. In trade relations, factoring has established itself as a useful economic means to overcome problems with the free movement of goods, services and capital. Such problems face the small and medium-sized entrepreneurs involved in the sale of goods or services who offer trade credits, i.e. they supply the goods they produce, or offer services without being paid at the time of the purchase of the goods or services: the payment is deferred for a period of 30, 60, 90 or maximum 120 days¹. The problems that these entrepreneurs successfully solve through factoring are: shortage of liquid cash money; credit risk (the so-called *del credere* risk); lack of sufficient resources for providing quality administrative and accounting services, and in some cases, any such services. The problems above identify the three main functions of factoring: these are financing, assumption of credit risk and provision of administrative and accounting services.

The functions of factoring are related to the trade credits offered. This relation is manifested not only by the trade credits offered that determine the economic functions of factoring, but also by the mechanisms for carrying out these functions. They are fulfilled through the sale of existing outstanding accounts receivable as well as the sale of future receivables for goods sold on credit or, respectively, services provided on credit.

The entrepreneurs involved in factoring who supply the goods or services under the conditions of trade credit are called “suppliers” (“clients” in English, or “Klient”, “Anschlußkunde” in German). Their business partners who take advantage of the offered trade credits are called “debtors” (“customers” in English, or “Kunde”, “Drittschuldner”,

¹ The period of deferred payment has been established in the trade practice. See: *Lunckenbein Hans G.*, *Rechtsprobleme des Factoring-Vertrages*, Diss. München, 1983, S. 9, *Martinek Michael*, *Moderne Vertragstypen: Band 1 Leasing und Factoring*, Verlag C.H. Beck, München, 1991, S. 228, *Frye Kevin*, Factoring may solve your firm’s cash flow problem, *Business First – Louisville*, 03/17/2000, Vol. 16, Issue 33, p. 13.

“Abnehmer” in German). The parties, called “factors”, purchase the receivables of the suppliers, and provide them the following services: financing, assumption of the credit risk and provision of the administrative and accounting services needed for these receivables.

The financing function is performed by the factor that makes an advance payment i.e. before the due date of the receivable, to the supplier amounting to between 70 and 90% of the nominal value of the purchased accounts receivable². The remaining 10-30% the factor withholds as a protection in case the supplier does not provide the goods or services as specified in the contract with the debtor. This part of the receivables is paid to the supplier within a period agreed with the factor; this period begins on the day after the due date of the receivable, and the duration of this period cannot exceed 120 days³.

The advance financing provided by factoring is used by the supplier during the period in which the debtor uses the trade credit obtained from the supplier. For this period, in essence, the factor gives a credit to the supplier. Taking into account the period of this credit, the economic literary sources describe factoring as a form of short-term financing⁴.

The financing function of factoring allows suppliers of goods or services to successfully solve the problem of shortage of liquid cash money. Overcoming this problem has a positive effect on the subsequent development of their business activity in the following areas:

The cash resources obtained through factoring give the opportunity to the suppliers to expand the range of the goods they produce or the services they provide as well as to continue offering trade credits. It should be noted that the trade credits offered have a number of advantages for the suppliers: for example, timely sale of the goods produced or services provided as well as an enlarged circle of business partners. For the latter, the benefits from the sale of goods or provision of services on deferred payment terms is, economically, very favorable because, in this way, they have the necessary resources for production before having accumulated funds for it.

The suppliers of goods and services who due to factoring have available liquid cash money are able to purchase goods from their suppliers paying them right away. Thus, they become the preferred business partners in trade relations, which gives them a number of advantages such as better prices and discounts.

Considering its financing function, factoring is especially convenient for small and medium-sized entrepreneurs. The limited amount of their own capital⁵ makes it difficult for them to receive bank credits, and to secure these credits. In order to allow a

² *Lunckenbein Hans G.*, op. cit., S. 8, *Björn Birgitte*, Factoring a comparative analysis the legal and practical implications of factoring as practised in the United States, England and Denmark, Copenhagen Jurist-ogÖkonomforbundets Forlag, 1995, p. 29 и 44, *Rademacher Kevin*, Factoring an option for generating quick cash, Inside Tucson Business, 05/31/1999, Vol. 9, Issue 10, p. 4, *Piperkova Lilyana*, Legal Aspects of Franchising, Leasing and Factoring, Sofia, 1995, p. 110, *Naydenov Borislav*, Commercial Transactions, Book One, Sofia, 1998, p. 154, *Petkov Georgi*, Taxation of Factoring, Journal of Bulgarian Law, vol. 12/2000, p. 97.

³ See *Georgieva Maria*, What is Factoring?, Journal of Finance and Law, vol. 2/1995, p. 8-11

⁴ *Stefanova Penka*, Banks and Credit Mediation, Sofia, p. 317

⁵ Own capital (or equity) comprises the basic and additional capital. The basic capital is the one registered in the Trade Register, and it must meet certain legal requirements. The additional capital are the assets not included in the basic capital. See *Ognyan Gerdjikov*, Comments on the Commerce Act, Book Two, Sofia, 2000, p. 380.

credit, banks research the creditworthiness of suppliers, and factors research the creditworthiness of suppliers' business partners, the trade credit debtors. Therefore, if a supplier does not meet the requirements for a bank loan, and such a loan has been refused, then this supplier is able, through factoring, to obtain the necessary financial resources under the condition that the supplier's trade credit debtors are creditworthy, and have a good trade reputation⁶.

In addition, the financing function of factoring means that suppliers have better opportunities to receive additional loans from banks. The advance payment received for transferred receivables results in reducing the amount of each receivable i.e. increasing the assets and reducing the liabilities of a supplier. This means improved balance sheet positions, leading to enhanced supplier's creditworthiness.

Owing to the above mentioned advantages, factoring is considered one of the most convenient ways for payments on contracts for supply of goods or for provision of services, and it has established itself as an attractive alternative among the other forms of short-term financing⁷.

The second function of factoring, assumption of credit risk, is served when the factor assumes the risk of possible non-payment by trade credit debtors due to insolvency or unreasonable refusal to pay the debt.⁸

When assuming the del credere risk, the factor is obliged, even without receiving payment by the debtor, to pay the purchased receivables to the supplier.

The factor assumes the del credere risk only of the receivables which it has approved in writing. Therefore, it is possible in trade relations between the same factor and supplier, the factor to assume the credit risk of certain receivables and not of others.

A prerequisite for the approval of a receivable is the positive result from the factor's research on the debtor's solvency with regard to a particular receivable. The factor assesses the debtor's solvency on the basis of the same criteria that banks use for evaluating the creditworthiness of their clients.

The economic significance of the del credere function is assessed in the light of the advantages it has for suppliers of goods or services with regard to the economic activity they perform. The del credere function of factoring provides a guarantee that suppliers will collect the full amount of their receivables for the goods or services provided. This also allows them to continue using the advantages of trade credits.

At the same time, through assuming the del credere risk, factoring provides suppliers a quick access to cash which is not obtained as a result from lengthy court proceedings or enforcement procedures.

The third function of factoring is manifested through the provision, to the supplier by the factor, of various administrative and accounting services related to the transferred receivables. It is customary for the factor to undertake the accounting of these receivables, to issue and send invoices, to send reminders for outstanding payments, to

⁶ *Frye Kevin*, op. cit., p. 13, *Abed Nikmat*, Factoring: an alternative cash flow funding method, San Diego Business Journal, 08/25/1997, Vol. 18, Issue 34, p. 14, *Lee Greg*, How to use factoring to grow your business, Business West, Feb. 1997, Vol. 13, Issue 10, p. 45.

⁷ *Bobatinov Mario*, Banking Law, Sofia, 2000, p. 159 and 166, and *Prokopieva Vasya*, Nature and Applications of Factoring, Journal of Market and Law, vol. 12/1998, p. 31-39.

⁸ The trade credit debtor's refusal to pay is not unreasonable when this refusal is based on failure on the part of the supplier to fulfill its obligations under the contract for supply of goods or, respectively, provision of services. In this case there is no credit risk.

collect these payments including taking enforcement actions against defaulting debtors, to research the solvency of third parties such as potential clients of supplier's business partners, to advise the suppliers on tax and financial issues, and on matters related to their investment policies, business activities, the advertising of the goods and services they offer, and the opportunities for entering the international markets. The factor may have the obligation to provide regular information to the supplier about the balance of its debtors' accounts, and changes in their solvency, to make aggregate analyses and consolidated balance sheets, as well as financial forecasts and development strategies. In international factoring, the factor usually controls the movement of goods, including their storage, sorting, transportation, insurance and customs clearance.

The economic significance of the third function of factoring should be assessed in the light of one of the trends in contemporary trade relations, the so-called outsourcing or transfer of business activities. It is characterized by relieving entrepreneurs from certain activities related to their business operations, and subcontracting external consultants who are highly qualified professionals in possession of extensive and constantly updated databases to provide expertise and services.

The need for external professionals occurs due to the lack of resources for quality implementation of the above mentioned activities or because of total incapacity to implement these activities. Through the employment of highly qualified external consultants, suppliers overcome this problem.

The economic functions of factoring reflect the practical needs that have brought it to life. Considered separately, these needs could be met by using the services of the traditional enterprises such as banks, insurance companies, companies specializing in debt collection, and companies providing accounting services.

The special feature of factoring is that it combines the financial and non-financial services provided by a number of different enterprises, linking these services to the trade credits offered; the economic objective is to create favorable conditions for the expansion of suppliers' trade activity. This characteristic distinguishes factoring from the other financial activities. It reflects its economic significance which is the basis for the establishment of factoring as a new form of economic collaboration.

3.1. Important for the clarification of the legal concept of factoring is Art. 1, Para. 2 and Para. 3 of the Convention on International Factoring⁹. Although it not part of the current Bulgarian legislation¹⁰, the Convention on International Factoring is being analyzed in this paper for the following reason:

⁹ The Convention on International Factoring was signed at the diplomatic conference in Ottawa, Canada held from 9-28 May 1988. A delegation from the Republic of Bulgaria also took part in this conference.

Work on the Convention, however, began in 1974 when the Governing Council of the International Institute for the Unification of Private Law (UNIDROIT) decided to include factoring in its work program. The preliminary draft of the Convention entitled "Uniform Rules on Certain Aspects of International Factoring" was ready in May 1983, and it was presented to the representatives of the member states of UNIDROIT to express their opinion. This draft was revised at three consecutive meetings of the commission whose members were governmental experts and representatives of international and national organizations such as the International Chamber of Commerce, Paris, the International Factors Group, Brussels, the Association of British Factors, London and etc. See *Piperkova Liliana*, op. cit., p. 119.

¹⁰ The Convention on International Factoring is not ratified by the Republic of Bulgaria, and therefore it is not part of the Bulgarian legislation. See Art. 5 Para. 4 of the Constitution of the Republic of Bulgaria.

The term "factoring" is legally defined. In Art. 2, Para. 2, Item 12 of the Credit Institutions Act, factoring is among the banking activities defined as forms of financing where financing is performed through the acquisition of accounts receivable arising from credits. The Credit Institutions Act does not provide the specifics of factoring which distinguish it from the other similar forms of financing. This lack of clarity of the Bulgarian legislation on the structure of factoring as a legal phenomenon is overcome by referring to the Convention on International Factoring. The Convention on International Factoring outlines the legal model of factoring which summarizes the characteristics of this legal phenomenon in accordance with the established trade practice. This model should be adopted by everyone who uses factoring in their businesses in Bulgaria.

The analysis of Art. 1, Para. 2 and Para. 3 of the Conventions on International Factoring shows that the legal structure of factoring involves a contract for supply of goods or, respectively, provision of services on the one side, and a factoring contract, on the other side.

It should be taken into account that the contract for supply of goods and the contract for provision of services are two separate legal transactions, each being an alternative to the other as an integral part of the structure of factoring.

The contract for supply of goods or, respectively, provision of services is signed between the supplier and the debtor, and the factoring contract - between the supplier and the factor.

Since the contract for supply of goods or, respectively, provision of services, and the factoring contract give rise to legal relationships, factoring in legal terms can be characterized as a system of two related legal relationships.

The legal concept of factoring should be also explained taking into account the specifics of the Bulgarian civil and commercial legislation. They are reflected in the first element in the structure of factoring: the contract for supply of goods or, respectively, provision of services.

3.2. The term "contract for supply of goods" is used in the Bulgarian legislation although it does not define a separate type of contract. This is because the current Bulgarian civil and commercial legislation does not make provisions for "the contract for supply of goods" as a separate type of contract. The term is used to define legal actions, meaningful only within the framework of the act in which there are provisions for them (Art. 6, Para. 1 of the Value Added Tax Act and Art. 3, Para. 1 of the United Nations Convention on Contracts for International Sale of Goods¹¹).

Article 6, Para. 1 of the Value Added Tax Act defines "the supply of goods" as a legal transaction involving a transfer of the right of ownership or other property rights of goods.

According to Art. 3, Para. 1 of the Vienna Convention on the International Sale of Goods, the object of the contract for supply of goods are the goods that will be manufactured or produced; with regard to its legal consequences, this contract should be

¹¹ The United Nations Convention on Contracts for the International Sale of Goods, also known as the Vienna Convention on International Sale of Goods, was ratified by the Republic of Bulgaria with Decree № 264 of the Council of Ministers of 13 March 1990 promulgated in State Gazette 23/1990. The convention entered into force in Bulgaria on 8 January 1991. Therefore, it is part of the Bulgarian legislation in accordance to Art. 5, Para. 4 of the Constitution of the Republic of Bulgaria.

treated as a contract of sale except in the cases when the assignor is obliged to supply a substantial part of the materials required for the manufacture or production of the goods.

The interpretation of Art. 6, Para. 1 of the Value Added Tax Act and Art. 3, Para. 1 of the Vienna Convention on the International Sale of Goods, in the light of the nature of factoring as an economic activity, leads to the following conclusions about the contract for supply of goods:

The contract for supply of goods is a contract for pecuniary interest, and it involves property transfer. Considering this characteristic, it should be understood as both a contract of sale and a contract of manufacture. However, not all contracts of manufacture involve transfer of property. Contracts for toll manufacturing in which the assignor supplies the substantial part of the materials required for the production of goods do not involve such transfer¹². These contracts should be excluded from the types of contracts of manufacture which are considered contracts for supply of goods.

Not all contracts of sale and of manufacture can be part of the structure of factoring, but only these whose object are goods. What is the content of the concept of goods?

The term "goods" is legally defined: Art. 1, Para. 1, Items 1 and 2 of the Commerce Act. The Bulgarian legislation contains legal definitions of this term, but they are only used within the acts in which they are found¹³. The Supreme Court has also given an interpretation of the content of the term "goods"¹⁴.

On the basis of the analysis of the legal definitions, and the legal practice, it can be concluded that "goods" are products of labor activities, possessions intended for consumption which are supplied or made available in the process of performing trade activities.

The characteristic of goods as possessions raises the question whether "goods" should be understood only as movables, or that the concept applies to both movables and immovables. The Bulgarian legal literature supports both views¹⁵. It is more correct to define only movables as goods. This understanding corresponds to the provisions of the Bulgarian legislation: Art. 1, Para. 1, Item 1, 2 and 14 of the Commerce Act show that the law excludes immovables from the concept of goods.

In conclusion, the term "contract for supply of goods" should cover contracts of sale and contracts of manufacture excluding contracts for toll manufacturing. The object of such a contract are goods, i.e. movables which are products of labor activities, and are exchanged in trade relations.

¹² Decision № 1243/7 July 1997 of the Supreme Court of Cassation, civil case № 1288/1996, civil division 5

¹³ Art. 13, Item 13 of the Consumer Protection Act and Art. 5 of the Value Added Tax Act

¹⁴ Interpretative Decision № 90/28 October 1982, criminal case № 52/1982

¹⁵ Peter Dzhidrov expressed the opinion that everything that can be traded is "goods"; he stated that, therefore, goods can involve both movables and immovable, individual rights, business enterprises and etc. See Comments on the Commerce Act, vol. 4, Sofia, 1994, p. 1109. The contrary view was expressed by *Luben Dikov*, A Course in Commerce Act, vol. 2, Sofia, 1992, p. 583-584, and *Maria Pavlova*, Commercial Transactions - Concept and Types, Journal of Commercial Law, vol. 2/1997, p. 13.

3.3. There are no provisions for the contract for services in the current Bulgarian civil and commercial legislation. However, the Bulgarian legal literature has studied its characteristics¹⁶.

This contract has a specific object: services. A service is an intangible benefit. It is defined as a positive action which is performed in compliance to the contract; it is not associated with the production of goods, or the transfer of individual rights of ownership, but it aims to serve particular individual or public interest.

This contract is concerned with the specific nature of the service regarded as an activity, and not the result of this activity.

The contract for services is a contract for pecuniary interest for the activity performed i.e. the provided service is always remunerated regardless of what result is achieved.

Like the contract for supply of goods, the contract for services which has the above mentioned characteristics can be an element of the structure of factoring.

3.4. The factoring contract is the second element of the structure of factoring.

There is no legal definition of a factoring contract which applies to the entire Bulgarian legislation. The legal definition of a factoring contract is provided in Art. 1, Item 11 of the Corporate Income Tax Act. However, the scope of application of this definition is too limited - only within the framework of the act in which it is contained.

The factoring contract is defined in Art. 1, Para. 2 and Para. 3 of the Convention on International Factoring.

The analysis of these legal definitions allows making the conclusion that, on the basis of the factoring contract, the supplier is obliged to sell the factor its existing outstanding accounts receivable as well as future receivables arising from contracts for supply of goods or provision of services; the factor, in return for remuneration, is obliged to provide to the supplier at least one of the following services: financing, assumption of the del credere risk, provision of the administrative and accounting services related to the transferred receivables.

4. On the basis of the analysis of the economic functions of factoring and their legal manifestation, it can be concluded that factoring, in legal terms, is a system of two related legal relationships: the first arising from the factoring contract, and the second from the contract for supply of goods or, respectively, of provision of services.

In legal terms, the specific connection of the three functions of factoring with the offered trade credits is manifested, on the one side, in the accessory relation between the two contracts: the main (determining) contract is the contract for supply of goods or, respectively, provision of services, and the accessory (determined) contract: the factoring contract; and, on the other side, in the requirement of the factoring contract which says that its object are the supplier's outstanding receivables arising from the contract for supply of goods or provision of services. These receivables determine the legal obligations of the factor which are an element of the legal relationship of the factoring contract. It is through the fulfillment of these obligations that the three basic functions of factoring are implemented.

¹⁶ See *Goleva Polyva*, Contract Law, Sofia, 2004, p. 228-230, and *Tsenova Lyubka*, Legal Regime of the Transactions for Services in the Value Added Tax Act, Journal of Commercial Law, vol. 3/1997, p. 46-47

The economic nature of factoring and its legal manifestation show both the usefulness of factoring as a market economy instrument, and the legal means for its application in trade relations. The practical significance of the research question lies not only in the important knowledge it provides to the Bulgarian entrepreneurs about this new and different form of economic collaboration, but also in the valuable ideas the paper suggests for future law-making related to factoring.