

True Sale or Not - the Nature of the Factoring Agreement

Did you know...

it has been argued that a factoring arrangement over invoices of a company could be challenged as a charge over book debts and thus is void against liquidators of the company unless registered under section 80 of the Companies Ordinance.

It is common for banks to make available trade facilities to trading entities through a factoring arrangement over the entities' invoices. In a typical factoring arrangement, the trading entity would sell its rights over the invoices to the bank in return for a sum of money as the purchase price. The purchase price would be at a certain percentage discounted from the invoiced amount. The bank would retain the right of recourse against the trading entity if the customer fails to settle the invoices.

The line between an absolute sale of the invoices and a charge over book debt as security is blurred when the economic effect of the two is likely to be the same if not similar.

Despite the fact that factoring arrangements are well-established in the banking industry, the issues pertaining to the force and effect of a factoring agreement remain alive as evidenced in the recent case of *Hallmark Cards Incorporated v Yun Choy Ltd (In Compulsory Liquidation)* (the “**Company**”) and *Standard Chartered Bank (Hong Kong) Limited* (the “**Bank**”) [2011] 5 HKC 453.

In Yun Choy's case, the liquidators sought to argue that the receivables purchase agreement over invoices for goods sold to Hallmark Cards entered between the Company (prior to liquidation) and the Bank was not a true sale of the Company's book debts, but was in substance an assignment by way of security creating a fixed charge over the book debts. Such a charge, the liquidators claimed, was void against

them as it was not registered under the Companies Ordinance.

It was common ground between the parties that the receivables purchase agreement was not a sham agreement and therefore the court was asked to look at the terms of the agreement to ascertain whether it amounts to an absolute sale of invoices.

The liquidators' key arguments related to the economic effect of the receivables purchase agreement which were:

1. The receivables purchase agreement was not a true sale as the risk of non-payment of an invoice remained with the Company and did not pass to the Bank.
2. Furthermore, as the Company was entitled to receive payments made by Hallmark Cards which exceeded the purchase price paid by the Bank in substance the arrangement was not a sale to the Bank. The receivables purchase agreement was more akin to security.
3. If payments made by Hallmark Cards were less than the purchase price, the Bank was contractually entitled to recover the balance from the Company.

The liquidators also submitted 2 other grounds in the event that the above arguments failed which relate to whether consideration was given for the sale and whether section 48 of the Bankruptcy Ordinance is applicable rendering an assignment (even if it was a true sale) over book debts void against the liquidators.

The court disagreed with the liquidators on all grounds.

The court was of the view that all of the features of the arrangement that the liquidators pointed to

relate to the economic effect of the arrangement which were not inconsistent with the legal nature of a true sale of receivables. There was no issue of consideration and section 48 of the Bankruptcy Ordinance was not applicable.

This case serves as a useful reminder that while the economic effect of the factoring arrangements is less of a concern, care should be taken to ensure that the terms of the factoring agreement clearly provide for the absolute assignment of all rights relating to the book debt to the bank and for title over the book debt and rights of collection to vest with the bank. The court will consider the legal rather than the economic substance of the arrangement when construing the factoring agreement.

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