



Ivane Javakhishvili Tbilisi State University
Faculty of Law

Journal of Law

№2, 2018



სანივერსიტეტის
განმომცემლობა

UDC(უბკ) 34(051.2)

ბ-216

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ISSN 2233-3746

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Certain Aspects of Regulation of Factoring in Georgia

The article below considers certain specifics of legal institute of factoring and issues connected with regulation of this financial service in Georgia. Effective legislation factually ignores factoring and this set on the agenda necessity of comprehensive processing of this legal field on legislative as well as on scientific level. Discussion provided in the article is based on analysis of legislation and practice of various countries. Taking into account the international experience, the article presents proposals for regulation of factoring in Georgia. Pursuant to author's view, factoring which is traditionally considered as a regulated field of economics, should preferably fall under supervision of regulatory body but at the same time such supervision should not complicate delivery of factoring services and activities in the area of mentioned legal institute should be attractive, profitable and interesting for an entrepreneur. Along with the achievements of foreign countries in the field of factoring, the article refers to experience gained in inter-agency working group dedicated to factoring law reform and factually presents certain outlines of Georgia's future factoring legislation.

Key Words: Factoring, Financial Service, Factoring Company, Commercial Bank, Micro-finance Organization, National Bank of Georgia, Licensing, Supervision, Reporting.

1. Introduction

A number of obstacles hinder the full-scale development of entrepreneurial activities in Georgia. Lack of working capital is one such major issue. Georgian small and medium enterprises (SME) suppliers are commonly required to provide trade credit to their large buyers and to hold accounts receivable on their balance sheets. This creates funding problems to SMEs that typically lack cash flow and may have difficulties accessing other sources of funds. Developed markets have established a highly efficient solution to face the problem, namely, factoring, which can help suppliers since it allows relatively easy and quick access to working capital by SMEs.

The Georgian legislation in force does not contain any detailed provisions on factoring, except for a brief mention of factoring in the Georgian Banking Law and several less noteworthy regulations, which broadly define factoring as a trade finance transaction¹ where the financing of a client's working capital includes a collection of accounts receivable, lending against accounts receivable, guaranteeing foreign exchange and credit risk. The Banking Law does not define different permutations of factoring services and only mentions that factoring services can be offered with or without recourse.

Georgian factoring companies do not require any license or permit if they are properly registered with the Registry of Entrepreneurial and Non-Entrepreneurial (Non-Commercial) Legal Entities (Entrepreneurial Registry) maintained by the National Agency of Public Registry of the Ministry of

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¹ Article 1.p., Law of Georgia on Activities of Commercial Banks, 23/02/1996.

Justice of Georgia. There is no specific supervisory body or regulatory mechanism of Georgian factoring companies. As factoring is not regulated, there are no limitations on the types of receivables subject to factoring.

Therefore, proper regulation of factoring is on the agenda along with the establishment of the scope of the relevant legislation to ensure stability of the market and legal efficiency of the transactions, while not putting undue regulatory burden on the industry.

Thus, it is desirable to encourage the development of factoring services by guaranteeing stability and legitimacy of the industry (ensuring that market players are well-established commercial entities capable of meeting certain regulatory requirements) as well as by raising legal certainty of factoring transactions.

According to international experience, the legal framework for factoring lies in the combination of the following three key elements: (i) the legal rules governing commercial contracts and assignment of receivables; (ii) the legal act establishing a regulatory framework and regulatory body with a mandate to regulate or supervise factoring; and (iii) the tax code and accounting rules and their application to factoring transactions and companies.²

2. Overview of Factoring Market in Georgia and the Advantages of Factoring

As Georgian law does not properly define and regulate factoring, there is no surprise that Georgian factoring market is currently underdeveloped and respective services are offered in a very limited volume. Currently, factoring operations in Georgia are mostly conducted by commercial banks, as most comprehensive regulation of factoring available at the moment is provided in 1996 Law of Georgia on Activities of Commercial Banks. Factoring, without being further defined is also a type of permitted activity for microfinance organizations pursuant to 2006 Law of Georgia on Microfinance Organizations.³ However, to the best of our knowledge, microfinance organizations in Georgia refrain from entering this segment, which is locally an unregulated field of financial activities and largely unknown.

For conducting factoring operations, respective service providers are not required to obtain any licenses, certifications or authorizations. Factually, the right to act in the capacity of a factor is granted to all Georgian commercial banks and microfinance organizations by virtue of respective banking license (applicable in relation to commercial banks) and registration with National Bank of Georgia (applicable in relation to microfinance organizations). Other types of commercial legal entities can theoretically also provide factoring services as such activity is not subject to specific licensing or permitting under 2004 Law of Georgia on Licenses and Permits. However, lack of regulation excludes participation of commercial legal entities, other than commercial banks and microfinance organizations from factoring operations.

² Comp.: Southeast Europe Enterprise Development, for the Establishment of Factoring Company in Bosnia and Herzegovina, 2007, 8, <<http://documents.worldbank.org/curated/en/440521468199442423/pdf/375110ENGLISH01ing1company01PUBLIC1.pdf>>, [28.09.2018].

³ Article 4.1.h., Law of Georgia on Microfinance Organisations, 18/07/2006.

Having conducted respective research of factoring market in Georgia, we can state that main providers of respective services are several commercial banks. In absence of proper legal framework for factoring in Georgia, these players of factoring market mainly rely on various sources of international regulation of factoring such as 1988 *UNIDROIT* Ottawa Convention on International Factoring, *UNCITRAL* Legislative Guide on Secured Transactions, other similar sources and best international practices in general.

Therefore, a brief overview of the advantages of factoring is not uninteresting to the reader.⁴ For example:

- Speaking about general advantages of factoring, first we can emphasize facilitating access to finance for SMEs. Factoring provides a quick boost to cash flow. This may be very valuable for businesses that are short of working capital. If done without recourse, factoring allows cash-strapped SMEs to increase their cash holdings and improve their balance sheets without taking on additional debt;

- Furthermore, proper regulation of factoring market leads to development of this industry and the more companies are conducting factoring transactions, the more competitive applicable service fees/prices become;

- Factoring also assists smoother cash flow and financial planning. It is noteworthy that some customers may respect factors and pay more quickly;

- Factors may give useful information for businesses about the credit standing of their customers and can further help them to negotiate better terms with suppliers;

- It is believed that factors can prove an excellent strategic – as well as financial – resource when planning business growth;

- Businesses would be protected from bad debts if they choose non-recourse factoring;

- Generally, the cash is released as soon as orders are invoiced, and such cash is available for capital investment and funding of next orders; and

- Factors will credit check the customers of applicable entrepreneurs and can help them trade with better quality customers.

3. Factoring Operations

In general, a factoring relationship is based on a contract between a client (supplier) and a factoring company. The contract usually starts with a preamble which defines the scope of the contract, its objectives and goals. This is followed by the main body of the agreement, which specifies the client's duty to offer (deliver) claims arising from supply (purchase, service) contracts, to the factor and the factor's duty to buy these claims (and conditions to be fulfilled in order for that obligation to arise).⁵ In this context, terms of payment, provisions on interest, allocation of risk (with or without

⁴ Comp.: *Klapper L.*, The Role of Factoring for Financing Small and Medium Enterprises, 2007, 6-7, <http://siteresources.worldbank.org/INTEXPOMNET/Resources/Klapper,_The_Role_of_Factoring_for_Financing_Small_and_Medium_Enterprises.pdf>, [28.09.2018].

⁵ *Orheian O. M.*, The Advantages of Using Factoring, as Financing Technique on International Transactions Market, The Annals of "Dimitrie Cantemir" Christian University, Economy, Commerce and Tourism Series, Vol. 9, 2012, 105-106.

recourse), services to be provided by the factor (maintenance of accounts, insurance, provision of information, etc.) and bank accounts involved in the transaction are particularly specific. At the end of the contract, there are provisions on the obligation to provide information, negative pledge clauses, and terms of agreement, contractual penalties, notices and jurisdiction in the case of dispute (usually arbitration).

Once the contract is signed, a typical factoring cycle consists of the following steps:⁶

- (1) The client sells goods or provides services to the customer in the ordinary course of business;
- (2) The client invoices the customer and sends a copy of the invoice to the factor, who then takes over sales ledger administration;
- (3) The factor applies credit control procedures. Once satisfied, it advances funds to the company at a discount (usually around 80% of gross invoice value);
- (4) The factor collects the debt from the customer when it is due; and
- (5) Once monies are received from the customer, the factor deducts an amount equal to the funds advanced to the company, the interest accrued on the daily outstanding balance of those funds and retains its fees. The balance is released to the client.

There are typically two costs involved,⁷ viz., a service charge expressed as a percentage of sales factored, and an interest charge for the cash advances. The service charge (commission), covering sales ledger management and collections services, usually ranges up to 3.0% of turnover. The primary considerations in determining the service charge are annual turnover, number of invoices and number of customers. The interest charges calculated on the daily usage of funds are typically comparable to secured bank overdraft rates.

4. International Standards for Factoring Services

In light of the 2013 Association Agreement between the EU and Georgia which, among other topics, implies harmonization of local legislation with EU standards, regulation of factoring at EU level could have been a major source for introducing new legislation in Georgia. However, since the factoring sector is not regulated by the EU, there is no comprehensive established definition of factoring at the EU level. Factoring is only mentioned as a service in several directives regulating credit and other financial institutions (e.g. EEC Directive 89/646 on the annual accounts and consolidated accounts of banks, etc.).⁸

The 1988 UNIDROIT Ottawa Convention on International Factoring (currently in force in nine countries) defines a factoring contract as a contract concluded between one party (the supplier) and another party (the factor) pursuant to which: (a) the supplier may assign to the factor receivables aris-

⁶ *Bakker M. H. R., Klapper L., Udell G. F.*, Financing Small and Medium-size Enterprises with Factoring: Global Growth in Factoring — and Its Potential in Eastern Europe, Warsaw, 2004, 6.

⁷ *Tatge D. B., Tatge J. B.*, Fundamentals of Factoring, Journal Practical Law, September, 2012, 65.

⁸ EU Second Council Directive 89/646/EEC on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC, 15/12/1989.

ing from contracts of sale of goods; and (b) the factor performs at least two of the following functions: (1) finance for the supplier; (2) maintenance of accounts (ledgering) relating to the receivables; (3) collection of receivables; and (4) protection against default in payment by debtors.⁹

Examples of legal definitions of factoring can be found in the national legislation of several European countries as well. For example, the German Banking Act (*Kreditwesengesetz*) defines factoring as the continuing acquisition of receivables on the basis of master agreements, with or without recourse,¹⁰ while the Latvian Commercial Code defines factoring as a contract under which one contracting party undertakes an obligation to acquire receivables of a client against a third person (debtor) as well as to fulfil other commitments specified in the factoring contract to another contracting party for the agreed remuneration.¹¹

In the absence of universal legal definitions, an analysis of general terms and conditions of factoring contracts used by factoring companies around the world indicates that factoring is a complex partnership agreement, covering a range of business services, commission fees, assignments and loan assumptions, customer research, accounting, billing and collections.¹²

From these various sources, it can be concluded that the core of factoring is a contractual relationship involving (a) a Supplier of goods and services, and (b) a factor to which the supplier sells (assigns) existing or future receivables arising from contracts of sale of goods or services made between the supplier and its customers (the Debtors), who are duly notified of the factoring contract.

The factor usually performs at least two of the following functions:

- 1) Provides finance for the supplier, including advance payments, through the purchase (transfer, assignment) of the receivables;
- 2) Maintenance of accounts (ledgering) related to the receivables;
- 3) Collection of the receivables; and
- 4) Provides protection against default in payment by debtors due to the debtors' inability to pay.¹³

5. Elements of Factoring

A factoring transaction implies several key elements which should be considered in the process of defining this financial service. Specification of the type of factoring, determination of whether the transfer of receivables represents a sale of receivables or a security agreement, implications of transfer

⁹ Chapter 2, UNIDROIT Convention on International Factoring, Ottawa, 28/05/1988.

¹⁰ §1, Punkt 1a, Nummer 9, Gesetz ueber das Kreditwesen (Kreditwesengesetz), 09/09/1998, <https://www.bundesbank.de/Redaktion/DE/Downloads/Aufgaben/Bankenaufsicht/Gesetze_Verordnungen_Richtlinien/gesetz_ueber_das_kreditwesen_kwg.pdf?__blob=publicationFile>, [28.09.2018].

¹¹ Sec. 468, Commercial Code of Latvia, 04/05/2000.

¹² Comp.: Klapper L., The Role of Factoring for Financing Small and Medium Enterprises, 2007, 5, <http://siteresources.worldbank.org/INTEXPCOMNET/Resources/Klapper,_The_Role_of_Factoring_for_Financing_Small_and_Medium_Enterprises.pdf>, [28.09.2018].

¹³ Comp.: *Institute of Chartered Accountants in England and Wales*, The Finance Function: A Framework for Analysis, 2011, 41, <<https://charteredaccountantsworldwide.com/wp-content/uploads/2016/09/Developing-effective-finance-functions-for-the-unique-contexts-within-which-they-operate.pdf>>, [28.09.2018].

of future receivables, defining the scope of factoring as well as distinguishing between factoring and non-factoring forms of receivables finance can be regarded as such key elements.

5.1. Types of Factoring

Various forms of factoring may arise when some, but not all, of the previously mentioned four functions are provided. The industry has developed various types of factoring contracts and these are commonly grouped together on the basis of three criteria: transfer of risk, places of business of the concerned parties and whether the debtor is notified.

Hence, according to those criteria, factoring transactions can be classified as:

- 1) Non-recourse and recourse factoring;
- 2) Domestic and international factoring; and
- 3) Disclosed (notified) and silent factoring.

In addition, current practices include an additional type of factoring in which the factor's client is the debtor and not the supplier creditor. This model of factoring is referred to as reverse factoring.¹⁴

5.1.1. Non-Recourse and Recourse Factoring

In non-recourse factoring, the lender not only assumes title to the accounts, but also assumes most of the default risk because the factor does not have recourse against the supplier if the accounts default. The factor may choose to pass on the credit risk by taking out credit insurance against non-payment of the debts. This type of factoring is also sometimes referred to as real, complete or standard factoring.¹⁵

Under recourse factoring, the factor has a claim against the seller for any account payment deficiency. Therefore, losses occur only if the underlying accounts default and the seller cannot make up the deficiency.¹⁶

5.1.2. Domestic and International (Export) Factoring

A major difference between domestic and international factoring is that domestic factoring involves parties which operate in a single legal system and use local currency, while the parties to international factoring operate in more than one legal system and in foreign currencies.

International (export) factoring covers the exporter's accounts receivable arising from cross-border deliveries of goods or services. International factoring can be organized through a two-factor system or as direct (import and export) factoring.¹⁷

¹⁴ *Regenbogen I.*, Reverse Factoring – Funding the Un-Fundable, *Romanian Review of Private Law*, Vol. 2, 2017, 115.

¹⁵ Comp.: *Allegiant Business Finance*, Factoring Guide, 2016, 3, <<https://www.allegiant1.com/wp-content/uploads/2016/09/FactoringGuide.pdf>>, [28.09.2018].

¹⁶ Comp.: *Ivanovic S., Baresa S., Bogdan S.*, Factoring: Alternative Model of Financing, *UTMS Journal of Economics*, № 2(2), 2011, 193.

Under the two-factor system, one company acts as the export factor – dealing with financing, credit management, sales ledger accounting, or a combination of these services – in the supplier's country. A second company, the import factor, handles credit cover and collection in the buyer's territory. Thus, functions and risks are divided between the import factor and the export factor. The main goal of this model is to use local credit and collection knowledge and to limit administrative costs. Factors usually establish cross-border business relationships through memberships in international factoring groups, which enable them to work effectively together in offering a total service to the end-user.

In the case of direct factoring, the accounts receivable are assigned to a factor located either in the export or import country. A problem with direct export factoring is that the factor in the exporting country can be faced with significant difficulties with the credit function (verification of solvency) and collection of claims, as the factor may lack local information and expertise. Import factoring, in which the receivables are assigned to the factor in the import country, is a more straightforward option than export factoring. However, if the client is operating in many countries simultaneously, this model could raise overall costs of transactions as the client needs to find suitable factors in each import country. Therefore, the two-factor system, in which the client enters into a single relationship with the home factor, may be a more convenient option.

5.1.3. Disclosed (Notified) and Silent Factoring

Factoring can be defined as disclosed or silent, depending on whether the debtor is informed about the assignment of the claim. Some experts consider this theoretical division to be obsolete, as most jurisdictions require a notice to be sent to the debtor, either to validate the assignment, or at least to make it opposable to the debtor (obliging the debtor to pay the factor).¹⁸ Therefore, silent factoring has practical use only if both the credit and collection functions are left with the client, in which case, we then have in fact an invoice discounting type of transaction. This form of financing is very popular in the United Kingdom, especially with larger companies that can afford the staff and information systems to efficiently manage and collect outstanding invoices.¹⁹

5.1.4. Reverse Factoring

Instead of entering into a contract with the supplier (creditor) as in a usual factoring agreement, under the reverse factoring scheme, the client of the factoring company is the buyer (debtor). This type of factoring product is also known as confirming (e.g. Spain) and sometimes as supply chain finance.²⁰

¹⁷ *RAI University*, Factoring — Theoretical Framework, 2011, 90, <<http://psnacet.edu.in/courses/MBA/Financial%20services/5.pdf>>, [28.09.2018].

¹⁸ Comp.: *Farrenkopf M.*, Corporate Finance Instrument: Single-Factoring and Sales of Defaulted Accounts (at the example of car dealers and repair service in Germany), Saimaa University of Applied Sciences, South Korea, 2014, 20.

¹⁹ Ibid.

²⁰ *Kouvelis P., Dong L., Turcic D.*, Supply Chain Finance: Overview and Future Directions, Supply Chain Finance, *Kouvelis P., Dong L., Turcic D.* (eds.), US, 2017, 3.

Eligible clients are usually large companies with strong market presence and many suppliers (e.g. large retailers). Instead of the assignment of receivables, the underlying legal relationship in reverse factoring is essentially assumption of the client's debt and subrogation of the supplier's claim by the factoring company.²¹

One of the advantages for clients in reverse factoring is in the possibility of decreasing administrative and processing costs by effectively outsourcing the payment department, i.e., the buyer makes one payment to a factor rather than to multiple suppliers. In addition, by providing suppliers with timely working capital financing, buyers can also improve their reputations and relationships with suppliers and still keep their working capital cycle based on deferred payments.

Essential to any reverse factoring scheme is the buyer's acceptance of the payment obligation and therefore close co-operation with the buyer. In this respect, an enforceable agreement is mandatory. Factoring companies and buyers usually enter into a mid to long-term framework agreement, setting the terms and conditions for the acceptance and advance payment of the buyer's accounts payable.

5.2. Sale of Receivables

In discussions on the legal nature of the transfer of receivables in a factoring agreement, much attention has been paid to whether the transfer in recourse factoring represents a sale of receivables from the client to the factor company or a security assignment.

Currently, there are three prevailing theories: purchase-contractual theory, commission-contractual theory and loan-contractual theory.²² Special attention has to be given to the loan-contractual theory, due to the possible consequences of its application on recourse factoring. This theory essentially defines recourse factoring as a secured loan transaction (by security assignment), with the collateral being transferred accounts receivable. Apart from the risk of making such transactions void if requirements for establishing collateral were not met (e.g. registration), such an interpretation may create additional risks as factored receivables may become part of the bankruptcy estate of the debtor in the case of insolvency. This question is especially relevant in those jurisdictions where inefficient bankruptcy regulations or priority rights of groups of preferential creditors in insolvency proceedings might dilute the value of the security over the accounts receivable.

Considering potential consequences of the application of such a definition, special attention has to be paid to a clear definition of the nature of the transfer of receivables when legislating factoring.

5.3. Transfer of Future Receivables

Future receivables are a potentially important source of factoring and should be included in any definition of factoring. When a commercial relationship is stable, the future cash flow from product

²¹ Comp.: *Klapper L.*, The Role of "Reverse Factoring" in Supplier Financing of Small and Medium Sized Enterprises, 2004, 9-10, <https://www.factoring-mittelstand.de/19_experiences.pdf>, [28.09.2018].

²² Comp.: *Kettering K. C.*, True Sale of Receivables: A Purposive Analysis, 2009, 514-515, <https://www.researchgate.net/publication/228220314_True_Sale_of_Receivables_A_Purposive_Analysis>, [28.09.2018].

delivery may be considered reliable, so a supplier may wish to factor these future receivables and a factor may wish to purchase these receivables. This is a common practice, which increases the flexibility of factoring as a financing instrument.²³

5.4. Scope of Factoring

The scope of factoring is usually limited to commercial/trade receivables and does not include consumer receivables (contracts for the sale of goods and services bought by individuals primarily for personal, family or household use). However, by some definitions, receivables arising from consumer services, such as utility or telephone bills, can be factored. In the United States, there are no restrictions, and receivables for any goods or services, regardless of the type of debtor, can be factored.²⁴ In some countries, a governmental or publicly-owned entity may not be a debtor in a factoring transaction.

It is also advisable to limit factoring services to the purchase of accounts receivable originating from trade to make sure that the developing industry stays focused on trade finance. Otherwise, there is a risk of the industry being misunderstood by its users (SMEs) and commingling with other types of financing usually not considered factoring, e.g., investing in non-performing loans (the NPL). This can have negative consequences for the reputation of the factoring industry that is usually misunderstood as a collection service or NPL management, which keeps SMEs away. This is usually done by defining receivables eligible for factoring as receivables which are still not due and payable (or exceptionally if already due, then to refinance them for a maximum one year) and which arise from sale of products and provision of services. In case this would be necessary in a particular jurisdiction, a law could provide more detailed description of what is considered trade and service provision, as well as to explicitly exclude NPLs.

5.5. Non-Factoring Forms of Receivables Finance

Factoring is one, but not the only, form of receivables financing. There are other forms of receivables financing that should not be confused with factoring. These include:

(1) Forfeiting, which involves the purchase or discounting of documentary receivables (promissory notes, for example) without recourse to the party from whom the receivables are purchased. Forfeiting involves financial rather than commercial transactions, and does not have the same collection properties, so it is not typically an activity of factoring companies. The terms factoring and forfeiting have been frequently confused. Factoring is suitable for financing several different smaller claims for consumer goods with credit terms up to 360 days, whereas forfeiting is used to finance capital goods exports with credit terms between a few months and seven years. It is noteworthy that 1996 Law of

²³ Comp.: *Akseli O.*, Turkish Law and UNCITRAL's Work on the Assignment of Receivables with a Special Reference to the Assignment of Future Receivables, *Law and Financial Markets Review*, Vol. 1, Issue 1, 2007, 47.

²⁴ Comp.: *Tatge D. B., Flaxman D., Tatge J. B.*, American Factoring Law, American Bankruptcy Institute, 2009, 44-46, <https://www.bna.com/uploadedfiles/abi_journal_review.pdf>, [28.09.2018].

Georgia on Activities of Commercial Banks duly (although superficially) defines forfaiting separately from factoring;²⁵

(2) Refinancing, which involves the assignment of receivables against some form of bank or other credit granted to the assignor;

(3) Securitization, which can involve issuance of securities backed by commercial receivables of various types, which are purchased by the securitization company (the issuer of the securities) from the commercial entity which originated the receivables; and

(4) Project finance, which involves loans to project contractors which are secured by future revenues generated by the project.

6. Currents Status of Factoring in Georgia

The most significant provisions of Georgian law in relation to factoring are provided in 1996 Law of Georgia on Activities of Commercial Banks, which broadly defines factoring as a trade finance and commission transaction relating to crediting of a client's working capital and encompassing the collection of the client's receivables as well as the credit and currency risk guarantees. The law does not define different permutations of factoring services. In particular, pursuant to Article 20 of 1996 Law of Georgia on Activities of Commercial Banks, such credit institutions may, among others, conduct factoring operations with and without the right of recourse.

Along with the banking law, factoring is mentioned in the 2006 Law on Microfinance Organizations (and related bylaws) as one of the types of activities which might be performed by microfinance organizations. Moreover, 2010 Georgian Tax Code considers factoring as one of the types of financial services/instruments.²⁶ Factoring is further mentioned in several less significant regulations. However, in all applicable pieces of legislation, factoring lacks a clear and comprehensive definition. As repeatedly stressed by representatives of Georgian legislative and executive power, commercial legal entities and international experts, Georgian legislation would benefit from exhaustive regulation of this form of financial service, including, but not limited to, defining specific types of factoring such as international factoring, reverse factoring, factoring of future receivables, etc.

Regulation of factoring market would increase legal certainty and support factoring service providers with developing new factoring products.

7. Proposal of Definition

7.1. Essence of Factoring

Based on international experience, it is desirable that factoring is defined as a legal transaction of purchase of existing or future short-term, non-matured receivables (with payment period up to 360 days) arising from a contract on the sale of goods or provision of services and conducted on repetitive basis.

²⁵ Article 1.s., Law of Georgia on Activities of Commercial Banks, 23/02/1996.

²⁶ Article 15.2.c., Tax Code of Georgia, 12/10/2010.

At the same time, reverse factoring might be defined as a special type of factoring based on a three-part contractual relationship between factor, client (debtor) and supplier (creditor), whereby the factor assumes existing or future short-term non-matured payables arising from a contract on the sale of goods or provision of services between the client and supplier, and undertakes to pay the assumed debt on call from the creditor for consideration (discount and factoring fee) before its maturity, being reimbursed the full value of the assumed debt by the client on maturity of the assumed debt.

7.2. Subject of Factoring

Pursuant to well established concepts of international financial law, subjects of factoring may be any existing or future, entire or partial, matured or non-matured short-term receivable arising from a contract on a sale of goods or provision of services.²⁷ A future receivable may be subject to factoring. A future receivable shall be deemed to be sufficiently defined if the factoring contract indicates the debtor under such receivable.

In addition to purchasing receivables, the factoring company may undertake to perform the following services:

- 1) Keeping records of and ledgering transferred receivables;
- 2) Collecting receivables; and
- 3) Assuming the risk of collecting transferred receivables.

7.3. Types of Factoring

Based on the location where a receivable is collected, factoring may be domestic or international. Based on the obligation to undertake the risk of collecting a receivable (*del credere* function) factoring can be with or without recourse.

(1) Domestic Factoring

It is recommendable to define domestic factoring in Georgia as factoring, the object of which is the transfer of receivables arising through the sale of goods or provision of services between domestic legal or natural entities.

(2) International Factoring

Desirable definition of international factoring would imply factoring, the object of which is the transfer of receivables arising through foreign trade in goods or services. International factoring may involve a one-factor system, in which the factor undertakes to collect, through its own agency, a receivable from a debtor domiciled abroad; or a two-factor system, in which the factor transfers a receivable or assumes a debt from another factor domiciled abroad in accordance with the terms and conditions of the factoring contract and the factoring law.

²⁷ Comp.: *EU Federation for Factoring and Commercial Finance*, Factoring and Commercial Finance: An Introduction, 2017, 3, <[https://www.intermarket.at/content/dam/at/intermarket/common/files/intro% 20to% 20factoring.pdf](https://www.intermarket.at/content/dam/at/intermarket/common/files/intro%20to%20factoring.pdf)>, [28.09.2018].

(3) Non-Recourse Factoring

Factoring without recourse shall entail the factor assuming the risk of collecting a receivable (including insolvency, bankruptcy and liquidation risk). The client shall be liable to the factor for the existence of a receivable; however, he/she shall not be responsible for the success of the collection (credit worthiness).

(4) Recourse Factoring

Under factoring with recourse, the factoring client (assignor) shall jointly and severally guarantee the successful collection of the transferred receivable. Where factoring with recourse has been provided for in the factoring agreement, the factoring client (assignor) shall be liable to the factor for the existence of a receivable, and for the collectability of a receivable as of the date the receivable becomes due.

Where the factor has exercised recourse, the factor may require that the client refund the advance payment increased by the amount of contractual interest, fees and expenses. Recourse factoring should not be characterized as a secured transaction. It is a form of title finance and should be treated as such. In contrast to collateralized loans, in a factoring transaction, the transfer of the receivable is the purpose of the transaction and not a guaranty for debt repayment. It is the value (solvency) of the transferred receivable that is guaranteed by the general right of recourse (claim) against the factoring client. In order to avoid negative implications of potential re-characterization of factoring with recourse into secured transaction (such as nullity, onerous enforcement restrictions, bankruptcy freezes, conflicts with negative pledge clauses, etc.), it is important that a clear and straightforward definition of the common types of factoring be included in national legislation.

(5) Bills of Exchange Discounting

The factor can engage in the practice of discounting of bills of exchange as long as the bill of exchange originates (represents a receivable) from the underlying transaction of sale of goods or provision of services. For regulating factoring in Georgia, discounting of such bills of exchange should be considered as purchasing the underlying receivables.

8. Factoring Legal Framework

Factoring has developed in a variety of legal and regulatory settings specific to the individual country in which factoring services are provided. However, factoring is almost universally understood as a combination of three contractual relationships: 1) framework agreements (setting conditions for assignments, services to be provided, fees, etc.); 2) contract on sale (or sometimes seen as a commission contract or even a loan); and 3) assignment of receivables (as a discharge of sale or provision of security for the loan).

The assignment of receivables lies at the heart of every factoring operation, and all European jurisdictions have more or less detailed laws regulating this practice. There are differences in the approach to assignment of rights (formal steps, opposability to a third party, assignment of future rights, etc.), but despite those differences it is safe to say that receivables can be more or less effectively assigned throughout Europe.

When analyzing the legal environment for factoring, special attention should be paid to the provisions regulating the form of the factoring agreement, assignability (and legal characterization of assignment) of accounts receivable; notification requirements, assignment of future receivables, contractual prohibitions on assignments, and third-party rights affecting factoring.

8.1. Factoring Contract

A factoring contract between a factoring firm and a client is a framework agreement regulating all aspects of the factoring relationship (e.g. type of factoring, recourse rights, provision of additional services, present and future assignments, etc.). It is the basis for provision of factoring services. It is structured as a revolving factoring facility (under which numerous individual accounts receivable are factored).²⁸ In practice, almost all factoring is performed on the basis of written factoring agreements.

8.2. Assignment

8.2.1. Assignment Form and Requirement of Notification

While a factoring agreement is a framework contract regulating all aspects of a factoring relationship between the factoring company and its client, assignment is the method by which transfer of receivables from a client to a factoring company is achieved.

European practice varies regarding the prescribed form of individual assignments.²⁹ Whereas in some countries such as Greece, Latvia and Portugal, the law requires assignments to be made in writing, assignment agreements in countries such as Malta and Sweden are not required to be in a specific form.³⁰ An informal approach to assignment is preferred, since a written form could increase the risk of assignments performed by electronic means.

In some jurisdictions (e.g. Norway and Czech Republic) notification of the debtor of the assignment is a legal requirement for the validity of assignment.³¹ Factoring companies in other countries (e.g. Great Britain, Poland and Portugal) need to notify the debtor not to make the assignment legally valid, but only to ensure that the debtor can discharge the debt by paying the factoring company only.

Notification should not be mandatory for the validity of the assignment. Such approach fully corresponds to respective provisions of Georgian Civil Code regulating assignment of claim.³² This allows companies to offer the service of silent factoring and reduces the risk of procedural errors during assignment. Furthermore, the law should support the validity of general notification that would include the assignment of future receivables (thus avoiding the need to notify each assignment specifically).

²⁸ Comp.: *Dogaru D. -M., Bratiloveanu I.*, Factoring Contract — Short Term Financing Technique, 2016, 29, <http://cis01.central.ucv.ro/revistadestiintepolitice/files/numarul52_2016/3.pdf>, [28.09.2018].

²⁹ Comp.: *Milenkovic-Kerkovica T., Dencic-Mihajlov K.*, Factoring in the Changing Environment: Legal and Financial Aspects, *Procedia — Social and Behavioral Sciences*, № 44, 2011, 433.

³⁰ *Ibid.*, 434.

³¹ Comp.: *European Bank for Reconstruction and Development*, Factoring Survey in EBRD's Countries of Operation, 2018, iv, <<https://www.ebrd.com/documents/ogc/factoring-survey.pdf>>, [28.09.2018].

³² Article 199, Civil Code of Georgia, 26/06/1997.

8.2.2. Assignment of Future Receivables

The possibility of assigning future receivables is an important feature for the factoring industry, as this enables establishment of long-term factoring relationships and may protect a factors' priority in case of competing claims. The majority of European countries allow for the possibility of assigning future claims. It is usually required that receivables and/or the debtor are determined or specified with sufficient precision for a future assignment to be valid.

For example, in Austria, a necessary requirement for the validity is the concretization and individualization of the claim.³³ This requirement is met, if, for example, all receivables arising in the business of the assignor are assigned. Whether the prospective debtor is known is not relevant as far as determination is possible. While the actual assignment cannot happen before the receivable is in legal existence, the framework agreement on the assignment can be made in advance. Whenever these receivables come into existence, they are automatically assigned to the assignee without a requirement for any further actions. Similar regulations can be found for example in Spain or Germany but with an additional requirement of identification of the future debtor.³⁴

8.2.3. Ban on Assignment by Virtue of a Contract

Contracts between small businesses acting as suppliers to large companies that dominate the market usually contain provisions prohibiting the assignment of receivables to third parties. This, in combination with long payment terms, may put such suppliers in a disadvantageous position, making it impossible for them to seek working capital from financial markets based on their accounts receivable.

There is no clear solution to this situation, as this is a typical example of conflict of legitimate interests. Should legislation governing factoring restrict freedom of contract by making it possible for receivables to be assigned even where contracts do not allow it? Is such an approach justified, and, if so, should it be governed by factoring legislation? Might it not be more appropriate to regulate this field through laws on competition?

Article 6 of the 1988 *UNIDROIT* Ottawa Convention on International Factoring stipulates that the assignment of a receivable by the supplier to the factor shall be effective, notwithstanding any agreement between the supplier and the debtor prohibiting such assignment. However, such assignment shall not be effective against the debtor when, at the time of conclusion of the contract of sale of goods, it has its place of business in a contracting state which has made a declaration under Article 18 of this convention.

1988 *UNIDROIT* Ottawa Convention on International Factoring, therefore, stipulates that any prohibition of assignment of receivables is to be deemed null and void, but nevertheless provides for possible exceptions to this rule. It should, however, be borne in mind that the convention deals with international factoring, which entails cross-border assignment of receivables and differing legal sys-

³³ Comp.: Bakker M. H. R., Klapper L., Udell G. F., Financing Small and Medium-size Enterprises with Factoring: Global Growth in Factoring — and Its Potential in Eastern Europe, Warsaw, 2004, 23.

³⁴ Comp.: Milenkovic-Kerkovica T., Dencic-Mihajlov K., Factoring in the Changing Environment: Legal and Financial Aspects, *Procedia — Social and Behavioral Sciences*, № 44, 2011, 343.

tems and powers. It reflects its own specific logic and rationale as well, especially regarding reducing information asymmetry, harmonizing legal rules and reducing regulatory risk.

In many European jurisdictions, contractual prohibitions on assignments are tolerated, possible and legally valid. However, the effects of such contractual prohibitions on factoring vary and range from the contractual prohibition having no effect whatsoever on the assignment and the factoring relationship (for example, in Austria, or in Italy, where a special law on factoring renders such contractual provision unenforceable) to the contractual prohibition rendering any assignment null and void and therefore making factoring in such cases practically impossible (e.g. in Spain, Czech Republic or Bulgaria).

The traditional reasons for allowing contractual freedom to prohibit assignments (the ability to control who your creditor is) are not valid in the case of factoring, since the assignees in factoring are legitimate companies offering legitimate, internationally recognized financial services. This argument becomes even more valid in jurisdictions where a certain level of regulation over the factoring industry already exists.

8.2.4. Priority Rights in Assigned Receivable

The extent to which competing rights can affect the factoring company as an assignee varies. It depends on the legal rights of a third party (e.g. conflict of several assignments over the same receivable, pledges over the assigned receivable or purchase of money security interests) as well as on how priorities are regulated in a particular legal system.

Rationales for determining the priority of competing claims differ among various jurisdictions, but the solutions are usually formed around several basic principles:³⁵

The first-in-time rule: The first party to sign a valid assignment agreement is protected, because from that moment on the transferor has no right to assign or to pledge something that he/she no longer owns. Therefore, any such disposition is not valid. The difficulty in this system lies in proving the date of the valid assignment, especially if no formalities are required.

The best title rule: The first one to register, if registration of assignment is required, or the first one to notify the debtor. The problem here is proof of perfection, i.e., who notified the debtor first.

Austria is an example of a jurisdiction that deals with priorities according to the first in time rule. Under Austrian law, if several assignments of one receivable conflict, the first assignment in time is valid and all further assignments will be considered void as the assignee cannot transfer more rights than it de facto holds. Similar laws apply in Belgium, Czech Republic, Italy or Germany.³⁶

On the other hand, in Bulgaria, the best title principle has been the basis for regulation of priorities. The notification of the debtor is mandatory for the assignment to be opposable to the debtor and to third parties (similar principles are applied in Ireland).³⁷

³⁵ Comp.: *Nishtani Y.*, Cross-Border Assignments of Receivables, Japan, 2017, 3-4.

³⁶ Comp.: *UK Factoring Association*, International Factors Group, Receivables Finance & ABL, A Study of Legal Environments across Europe, 2007, 23, 32, 36, 77, <<http://www.abfa.org.uk/members/newsletter/EU-LegislationReport.pdf>>, [28.09.2018].

³⁷ Comp.: *The British Institute of International and Comparative Law*, Study on the Question of Effectiveness of an Assignment or Subrogation of a Claim against Parties and the Priority of the Assigned or Subrogated

Romania is another example of a jurisdiction that bases the rules of priority on the best title principle. However, Romanian authorities have taken a somewhat different and perhaps unusual approach compared to other European jurisdictions. For the assignment to be opposable against third parties in Romania, it has to be registered with the electronic archive of pledges. In the case of successive transfers, the assignee who registered his/her transfer first shall have priority, no matter whether he/she knows about the existence of other transfers.³⁸

However, regardless of the principle on which priority rules are based, when examining the conditions for performing factoring in a particular jurisdiction, one should investigate whether the system allows for easy and certain determination and protection of priority positions of the assignees, in this case, factoring companies.

9. Georgian Legal Framework

In absence of proper definition of factoring under Georgian law, there is no surprise that local legislation does not regulate factoring agreement to any extent. It is proposed that the new factoring law should not only define factoring, but also introduce a definition of the factoring contract as well as define the parties and their duties and rights.

Taking into account the legal realities in Georgia, it is recommendable that factoring can be provided only on the basis of a written factoring agreement, in the following manner: Under a factoring agreement, the factor undertakes to purchase existing or future short-term non-matured receivables (up to 360 days) arising from a contract on the sale of goods or provision of services.

Parties to the factoring agreement are the factor (a credit institution in accordance with applicable laws and a factoring company providing factoring services), the client (a legal entity or individual selling accounts receivable) and the debtor (of sold accounts receivable).

A factoring agreement shall contain, in particular, information on the parties to the agreement; an indication of the type of factoring to be conducted, grounds for and information about the receivable that is the subject of the agreement, the amount and manner of calculating the factoring fee, the interest rate and other potential expenses.

10. Assignment of Claims

Transfer of receivables as execution of sale for the purposes of performing factoring is regulated by the provisions of the law regulating assignment (cession) of claims. According to Georgian Civil Code, the assignment of a claim is effected by a contract concluded between the creditor and a third party.³⁹ The contract does not have to be in a specific form, unless specifically requested by the as-

Claim over a Right of another Person, 2011, 338, <http://edz.bib.uni-mannheim.de/daten/edz-k/gdj/12/report_assignment_en.pdf>, [28.09.2018].

³⁸ Comp.: *UK Factoring Association*, International Factors Group, Receivables Finance & ABL, A Study of Legal Environments across Europe, 2007, 104, <<http://www.abfa.org.uk/members/newsletter/EU-LegislationReport.pdf>>, [28.09.2018].

³⁹ Article 199, Civil Code of Georgia, 26/06/1997.

signee. Until the debtor is notified of the assignment of the claim, he/she is entitled to pay to the assignor. If the assignor has agreed on the assignment of one and the same claim with a number of persons, then the person with whom the assignor entered into relations first shall be entitled to the claim. If this cannot be determined, then priority shall be given to the person notified to the debtor earlier. The assignor is obligated to hand over all documents in his/her possession with respect to the claims and rights, as well as all information that is required for use of these claims and rights, to the assignee.

Since there is no specific requirement for the written form of assignment, receivables can be validly assigned using electronic data exchange messages. Electronic signature is regulated, but it is not widely used in Georgian practice. Registration is not required for the validity of assignment and no stamp duty applies.

Analysis of Georgian legislation makes clear that contractual prohibition against assignment of receivables is permitted. A breach of such provision deems the assignment invalid.

There are no specific provisions on the assignment of future debt. However, it is considered that, from the perspective of contract law, there is no obstacle to assigning future debts as long as the debt is identifiable (the debtor has to be known, as does the relationship out of which the debt will arise). Confirming and reinforcing future assignments and general notices on future assignment might be a welcome change to the factoring services industry.

Provisions confirming this possibility and allowing for general notification of future assignments would be welcome. The assignment of receivables may be contractually prohibited and an assignment in contradiction with such a term would be effective towards the debtor. Parties should be free to agree on the recourse right of the assignee (factor) against the assignor (client).

There are no special provisions on electronic factoring. However, due to lack of requirements for the form of assignments, there should be no obstacles to electronic assignments. Introduction of certain *lex specialis* provisions, which would improve the legal stability of factoring operations and support the development of factoring services, would be useful for Georgian law. These are, in particular, provisions on prohibition of assignments, definition of future accounts receivable, general notice on future assignments and recourse right in the case of recourse factoring. Hence, it seems desirable to adopt the following regulations:

- The client shall at all times guarantee that any and all receivables sold are free of pledges, contestations, burdens and other rights of third parties and that such receivables may not be contested on any grounds, even when not explicitly agreed. Where any receivables sold are the subject of a pledge or objection by the debtor or other right of any third party, or if such receivables have been contested in any manner by the debtor or any third party, the factor shall have recourse against the assignor for such receivables, regardless of whether factoring with recourse or without recourse has been agreed on;

- Notice of the assignment of receivables may be given with respect to all receivables covered in a factoring agreement, regardless of whether they actually exist at the time the agreement was entered into;

- A future receivable may be subject to factoring. A future receivable shall be deemed to be sufficiently defined if the factoring contract indicates the debtor under such receivable; and

• Where the assignment of a receivable is prohibited under a contract between the client and the debtor, or the general terms and conditions of the debtor, such prohibition shall not have legal effect on the assignment of such receivables to entities permitted to provide factoring services.

11. Regulatory Framework

From the standpoint of public policy, three basic criteria are generally used to determine whether financial institutions should be subject to prudential regulation (licensing, supervision, reporting and capital adequacy requirements).⁴⁰

One of these criteria is whether the type of institution is a significant repository of savings of the public, such that the failure of this type of institution could cause a significant shock to general financial stability. A second consideration is whether the type of institution is a direct participant in the clearing and settlement of payments, such that the failure of a significant participant could disrupt the payments system. The third consideration is whether the type of institution is a source of credit with macroeconomic significance to the general economy.

If the type of institution does not accept deposits from the public, extends only modest amounts of credit, and is not a direct participant in the clearing and settlement of payments, (e.g. financial leasing and factoring companies), then there is dramatically less justification for subjecting such institutions to capital adequacy requirements and strict regulation in general.

The factoring community opposes strict regulation in general and the application of the Basel capital adequacy principles in particular. It is believed that the Basel framework does not properly consider the low risk level of factoring activities (as noted by the International Chamber of Commerce, European Banking Federation and Swedish Banker's Association).⁴¹ On the other hand, it is recognized that an appropriate level of supervision may add more legitimacy, respect and harmonization to the industry. Current practices across Europe vary from a liberalized approach to relatively strict regulation.

12. Examples of Regulation

12.1. Unregulated

The United Kingdom represents an example of an unregulated factoring industry.⁴² In the UK, each factoring company operates according to its corporate governance rules, contractual relationships and the Code of Business Practice, a framework developed by The Asset Based Finance Association (whose 40 members represent about 95% of the UK and Irish market). The only supervision exerted over

⁴⁰ Comp.: *Llewellyn D. T.*, Institutional Structure of Financial Regulation and Supervision: the Basic Issues, Washington DC, 2006, 5.

⁴¹ Comp.: *European Bank for Reconstruction and Development*, Factoring Survey in EBRD's Countries of Operation, 2018, iii, <<https://www.ebrd.com/documents/ogc/factoring-survey.pdf>>, [28.09.2018].

⁴² Ibid.

factoring companies is conducted by the FSA under Anti-Money Laundering Laws. Other examples of unregulated countries include Ireland, Belgium, the Netherlands, Poland, Slovakia, Switzerland, Russia, the Czech Republic, Lithuania, Luxemburg, Denmark, Estonia, Latvia, Slovenia, and Cyprus.⁴³

12.2. Types of Regulation

12.2.1. Regulation without Capital Adequacy Requirements

Factoring in Germany is considered a regulated financial service subject to the German Banking Act (*Kreditwesengesetz*). The reported rationale behind the decision to regulate the industry was the growing importance of factoring in Germany, especially for SME financing.⁴⁴ There were worries that missteps based on unsound management could cause significant damage, not only to the clients of the relevant company, but also to the industry as a whole. This danger was thought to be sufficient enough to put factoring companies under limited supervision. As a consequence, anyone who intends to provide factoring services in Germany is required to apply to the regulating agency (Federal Financial Supervisory Authority — *BaFin*) for a license. In addition, management has to be approved, qualified participating interests have to be reported, and evidence of the suitability of shareholders to hold qualified participating interests needs to be provided. There are also some internal organizational requirements, in particular with respect to risk management and outsourcing of activities. Obligations to submit annual accounts, management reports and auditor's reports on a regular basis have also been introduced.

However, capital adequacy requirements were not introduced in Germany. With respect to international factoring services provided in Germany, a license is not required if the relevant entity qualifies as a credit institution as defined by the European Banking Directive 2006/48/EC and has its seat in the European Economic Area. For all other companies wishing to provide factoring services, a German financial services license is required. Romania, Norway and Turkey are also examples of countries where some regulation has been imposed but no capital adequacy rules exist.⁴⁵

12.2.2. Regulation with Mitigated Capital Adequacy Requirements

Italy and Spain have aligned their regulation of factoring companies with Basel capital adequacy requirements with some relaxations in specific areas, in particular with respect to the capital adequacy requirement.⁴⁶ In Italy, companies are subject to capital adequacy rules arising from EU capital requirement directives and prudential risk-based supervision of the Bank of Italy. Supervision consid-

⁴³ Comp.: *Llewellyn D. T.*, *Intitutional Structure of Financial Regulation and Supervision: the Basic Issues*, Washington DC, 2006, 36-39.

⁴⁴ Comp.: *European Bank for Reconstruction and Development*, *Factoring Survey in EBRD's Countries of Operation*, 2018, iii, <<https://www.ebrd.com/documents/ogc/factoring-survey.pdf>>, [28.09.2018].

⁴⁵ Comp.: *UK Factoring Association*, *International Factors Group, Receivables Finance & ABL, A Study of Legal Environments across Europe*, 2007, 103, 127, 130, <<http://www.abfa.org.uk/members/newsletter/EU-LegislationReport.pdf>>, [28.09.2018].

⁴⁶ Comp.: *European Bank for Reconstruction and Development*, *Factoring Survey in EBRD's Countries of Operation*, 2018, iii, <<https://www.ebrd.com/documents/ogc/factoring-survey.pdf>>, [28.09.2018].

ers credit, operational, foreign exchange (FX) and trading risk. The introduction of capital adequacy requirements (which are lower than those for banks and weighted depending on the type of financing source) was based on the position of the Bank of Italy that greater transparency of the risk involved in lending to the factoring companies and their financial soundness would offer potential for growth and development of the industry.⁴⁷

In Spain, factoring companies which are a part of banking groups are regulated and supervised by the Bank of Spain. Capital adequacy ratio is somewhat relaxed for those factoring companies. Otherwise, for the independent factors, the minimum capital adequacy ratio is same as for banks.⁴⁸

12.2.3. Regulation with Full Basel Approach

Under Section 1 Paragraph 1 No. 16 of the Austrian Banking Act, the purchase of accounts receivable arising from delivery of goods or rendering of services, assumption of the credit risk on such claims – exempt credit insurance – and, in connection therewith, the collection of such receivables (factoring business) is considered a banking transaction and exclusively restricted to credit institutions which must be licensed by the Financial Market Authority (FMA) to perform such activities. Austrian credit institutions, including factoring companies, are required to calculate capital requirements under the Basel framework in accordance with applicable Austrian FMA regulation.⁴⁹

13. Proposed Georgian Regulation

When considering regulation of factoring in Georgia, one should take into account whether there is a need to impose the capital adequacy requirement upon factoring companies. In addition, the regulation should define criteria for establishing factoring companies (the form of the company allowed to provide services, control of the ownership structure, charter capital, permitted business activities and management requirements), and set rules for supervision, reporting and ensuring that certain market conduct (consumer protection) standards are met.

13.1. Capital Adequacy Requirements

In theory, the core argument for relaxed capital adequacy requirement in factoring is grounded on risk mitigation. While in case of standard loan, the default occurs in case of default of the client. In recourse factoring, both the buyer and the client should default to cause non-payment towards the factor.

Similarly, for non-recourse factoring, buyer's default risk is in most cases mitigated by the credit insurance provided to factor by a reliable insurer.

⁴⁷ Comp. *ibid.*

⁴⁸ Comp.: *UK Factoring Association*, International Factors Group, *Receivables Finance & ABL, A study of Legal Environments across Europe*, 2007, 49, <<http://www.abfa.org.uk/members/newsletter/EU-LegislationReport.pdf>>, [28.09.2018].

⁴⁹ Comp.: *European Bank for Reconstruction and Development*, *Factoring Survey in EBRD's Countries of Operation*, 2018, iii, <<https://www.ebrd.com/documents/ogc/factoring-survey.pdf>>, [28.09.2018].

In addition, stability of factors is the precondition for their ability to attract financing as the major source of financing for factors is the banking loan. Therefore, there exists a self-regulatory element in the form of difficult access to financing for those factors, which cannot demonstrate sound financial standing.

Last, but not least, in practice, there is no commonly accepted form of capital adequacy requirement for factoring. While no regulation of capital adequacy exists in most EU countries, those few countries requiring relaxed capital adequacy requirements scale the requirements either based on source of factor's funding or based on a factor's membership in group.

In conclusion, it is not recommended to introduce capital adequacy requirement at the moment. However, it might be considered within the regulatory framework to allow Georgian regulator to introduce certain requirements in this area in future. Both for the factoring market as a whole, and/or for individual factoring companies (with increased risk identified by the regulator), it might be beneficial to empower the regulator to issue calculation and reporting requirements on capital adequacy as well as to set up certain obligatory capital adequacy ratios.

13.2. Factoring Companies

A major area for decision in any regulatory framework for factoring is defining the criteria for determining who can perform factoring activities. Clear standards should be set regarding such areas as corporate form, minimum capital, ownership criteria, scope of business and required expertise.

13.2.1. Organizational and Legal (Corporate) Form

In some countries, there are no restrictions on the type of entity that may perform factoring activities. In others, such activities are highly restricted, for example, limited to licensed banks only. These are the two extremes. However, in most countries, especially in those emerging markets where factoring is a new service and is just being introduced, there is typically a set of criteria set forth in some regulatory form which stipulates minimum capital requirements. There may also be some stipulations as to the type of company and ownership.

The desired standard for such regulation should be to permit, even encourage, the establishment of legitimate factoring businesses, while ensuring a level of professional expertise and adequate financial backing to enable such businesses to function properly. If this balance is not struck, there is a risk, on one hand, that marginal entities may promote themselves on the market as legitimate factoring companies; on the other hand, the emergence of factoring could be stifled by overly onerous regulatory requirements which create barriers to entry.

I believe that it would be expedient to regulate that a factoring company shall be a legal entity registered in Georgia (entered into the Registry of Entrepreneurs and Non-Entrepreneurial (Non-Commercial) Legal Entities maintained by National Agency of Public Registry of Ministry of Justice of Georgia (hereinafter — “the Entrepreneur's Registry”)) and further licensed by the supervisory body. The company should be incorporated either as a joint stock company and/or a limited liability company. The term factoring and its derivatives in the company name may be recorded in the Entre-

preneur's Registry and may be used in legal transactions only by a company that has obtained a license to provide factoring services. As factoring is already a form of permitted activity for commercial banks and microfinance organizations, these entities should be entitled to perform respective services without separate registration or licensing.

Factoring activities should be permitted to be performed only by Georgian factoring companies, Georgian banks, microfinance organizations and a branch of a bank registered in a third country under terms and conditions defined in the regulations on banking operations in Georgia.

13.2.2. Supervision of Ownership

Many countries have no regulations or requirements of any kind regarding who may own a factoring company. At the other extreme, some countries permit factoring only by licensed commercial banks. A relatively restrictive set of ownership criteria limits shareholding in factoring companies to licensed banks and non-bank financial institutions or to factoring companies owned by such entities.

To permit development of factoring, this sector should be open to the participation of any investor who is able to meet certain general requirements (e.g. no bankruptcy records, money laundering or other criminal convictions, etc.). In order to allow for efficient supervision, introducing a requirement for prior approval of acquisition of a qualifying stake (10% of the voting rights or of the capital stock) in factoring companies (such approach is applicable in relation to commercial banks in Georgia) is recommended. In addition, the holder of a qualifying stake should request an approval from the supervisory body for acquiring a qualifying stake prior to any further acquisition of stakes or shares on the basis of which it exceeds 25 percent or 50 percent of the voting rights or of the capital stock (such percentages also aligned with current banking regulations).

13.2.3. Charter Capital

Required minimum charter capital is a key issue and various criteria have been set in various countries. The best guiding principle would appear to be to set minimum charter capital at a level which ensures serious shareholder backing, but not so large as to be an unnecessary barrier to entry or disproportionate to the real needs of a factoring business. Some countries have set a high minimum capital for factoring, at or near the level required for participation in Factors Chain International (USD 2 million). But this level of capital is not necessary for companies wishing to engage in the business of domestic factoring or direct import factoring.

Such a level of required minimum charter capital is excessively high and creates a barrier to entry and an impediment to the development of factoring. It is proposed to align the minimum required charter capital with the requirement for microfinance organizations in Georgia, i.e., at least GEL 1,000,000 in monetary contribution. The capital stock must be fully paid before the factoring company requests a license with the regulatory body.

13.2.4. Business Activities

Any existing or future, entire or partial, short-term receivable arising from a contract on sale of goods or provision of services may be subject to factoring. Apart from engaging in factoring, the factoring company may undertake to perform the following services as well:

- 1) Keeping records of and ledgering transferred receivables;
- 2) Collecting receivables;
- 3) Assuming the risk of collection of transferred receivables;
- 4) Discounting bills of exchange originated in the transaction of provision of services or sale of goods; and
- 5) Providing advice on organization of a ledger, etc.

13.2.5. Directors/Management

It may be appropriate to set some standards for experience levels of senior management of factoring companies, particularly when experience in managing financial or commercial businesses is required.

Hence, in my opinion, a law on factoring should follow the model of currently effective 2006 Law of Georgian on Microfinance Organizations, which requires that management of such entities comply with the criteria⁵⁰ as follows: university degree; corresponding expertise, skills and experience necessary for conducting the company operations; the individual should not have taken part in a transaction which inflicted significant damage to depositors or other creditors of a factoring company or credit institution (implying commercial banks, microfinance organizations or credit unions) or which resulted in insolvency/bankruptcy of such factoring company or credit institution; the individual was not convicted for serious, particularly serious heavy crimes (as defined under Georgian Criminal Code), money laundering and/or financing of terrorism and other economic crimes; the individual is not a shareholder, management member and/or a manager, member of supervisory board of another factoring company, etc.

14. Licensing, Supervision and Reporting

As current legislation factually indirectly implies supervision of factoring by the National Bank of Georgia (this is due to the fact that factoring is directly permitted for commercial banks and microfinance organizations), establishment of this institution as a regulator of factoring on legislative level seems fully expedient. However, currently effective Georgian legislation does not provide for any specific rules for supervision and reporting of factoring.

⁵⁰ Comp.: Article 7, Law of Georgia on Microfinance Organisations, 18/07/2006.

14.1. Licensing

For the purpose of perfection of local legislation on factoring, it is necessary to define National Bank of Georgia's authority in detail as well as procedures to be followed by the National Bank of Georgia and factoring companies when:

- 1) issuing and revoking licenses for conducting factoring activities;
- 2) issuing approvals for acquiring qualifying stakes in factoring companies, and
- 3) issuing and revoking approvals for management board members.

14.2. Supervision

The National Bank of Georgia should be authorized to exercise supervision over factoring companies except when banks or microfinance organizations perform them within the scope of their registered activities. National Bank of Georgia further shall have the power to supervise factoring companies and shall determine whether they operate in compliance with factoring laws and its implementing regulations, or with other laws and their implementing regulations that govern operations of factoring companies.

The National Bank of Georgia shall also have the power to supervise or to cooperate with other supervisory bodies in supervising legal entities affiliated with factoring companies, if necessary for performing supervision of the factoring company.

The factoring law should empower the National Bank of Georgia to request from the factoring company information about any activities which are important in determining whether they comply with the provisions of the law and its implementing regulations.

The National Bank of Georgia should have further powers to supervise factoring companies by monitoring, gathering and reviewing reports of the factoring companies; reviewing the operations of a factoring company, and imposing supervision measures. In conducting the supervision, the National Bank of Georgia should be able to perform the following actions: eliminate illegalities and irregularities (e.g. in cases when a company does not meet the conditions for conducting factoring activities; the company conducts an activity which is not allowed, the company violates regulations on bookkeeping and preparation of financial statements, and/or audit of financial statements; the company breaches the reporting regulations; etc.); revoke licenses; initiate a misdemeanour procedure; implement additional measures (e.g. to order adoption of measures in order to ensure solvency of the factoring company, to suggest appropriate decisions on increasing the share capital, to ban dealings with certain members of management, shareholders, etc., to order improvement of internal procedures, to order release of members of the management board in case of serious breach of duties, etc.); and prohibit unlicensed parties from conducting factoring activities.

The law should also set clear obligations for factoring companies to enable supervision activities on their premises, as well as on other premises where they perform their operations subject to supervision; enable review of business ledgers, business documentation and administrative records, business records within the limit necessary for conducting special supervision and/or within the limit

set in the law regulating special supervision; to submit computer generated records and/or copies of business ledgers, business documentation, administrative records and business records, etc.

Upon completion of supervision of operations of the factoring company, the National Bank of Georgia should prepare a supervisory report and submit it to the supervised company which must be entitled to file an objection regarding the supervision report to the National Bank of Georgia in accordance with the law governing administrative procedure.

14.3. Reporting

Proper management of accounts receivable (ledgering) is essential to the factoring business and systems for doing so must be part of a factoring company's knowledge base and operating procedures. The factoring company must organize its operations and maintain books, business documentation and other records in a transparent manner that enables determination as to whether the company operates in compliance with applicable regulations and industry standards.

Following the rules established for commercial banks and microfinance organizations, it seems expedient to specifically prescribe that all factoring companies (irrespective of their size, value of assets or annual income) are obligated to perform an annual audit of financial statements.

In addition, factoring companies should report changes to any basic data in the Entrepreneur's Registry; all decisions adopted at shareholders meetings, shareholders of the company and acquiring qualifying stakes and/or changes in the qualifying stakes; estimated opening, moving, closing or temporary terminating of branches or representative offices and/or other related changes; investments based on which the company acquired, directly or indirectly, qualifying stakes in another legal entity and all further investments in the same legal entity; and changes in the capital structure.

15. Market Conduct

Market conduct regulations seek to establish good business practices in disclosure of the terms and conditions of transactions so that clients can understand their rights and responsibilities in financial transactions.

I believe comprehensive overview of how various jurisdictions regulate market conduct of factoring companies would be overburdening for this article, as these vary from having the rules prescribed in special laws to more general legislation (such as consumer protection or general financial services regulation).

However, it can be stated that regardless of the approach, the following principles are generally followed:

- Fair treatment of customers (transparency of fees and charges, accessibility of general terms and conditions);
- Selling and advising in a responsible way;
- Providing adequate after sales service;
- Ensuring that product performance meets customers' fair expectations; and
- Transparent and fair handling of complaints and resolution of grievances.

A good market conduct regulation system built around these principles is especially important for fostering the general acceptance of the factoring industry as a legitimate and highly welcomed financial service by the general public. Transparent rules and regulations should make consumers confident in dealing with factoring firms.

In Georgia, the protection of individual consumer rights should be enforced in compliance with the law governing consumer protection in the field of financing services. Currently, this mainly applies to NBG regulations on Approval of Rules of Consumer Protection during Provision of Services by Financial Organizations (Order of the President of NBG № 151/04, 23/12/2016). However, the factoring law should provide that the amount, manner of calculation and payment of the fee due to the factor, as well as the entitlement of the factor to interest and any other expenses that may arise in the execution of the factoring agreement, should be clearly determined in the factoring agreement.

16. Conclusion

In the scope of this article there are considered certain specifics of factoring as a financial service, types of factoring based on international experience, current status of factoring in Georgia and perspectives of its development. Due to high global importance of factoring, Georgia cannot remain without detailed legal regulation of this field in compliance with contemporary standards. Accordingly, a number of issues have been identified which require regulation on legislative level. Among them, the main topic is adoption in Georgia of a new law on factoring, which should provide a comprehensive definition of factoring and each of its particular forms. This legislative act should refer to factoring companies; however, the majority of its provisions should further apply to factoring operations performed by commercial banks and microfinance organizations. Moreover, some definitions and references to factoring, currently envisaged under Georgian law, should be brought in compliance with the content of new factoring law, including:

- the Laws on Activities of Commercial Banks and Microfinance Organizations should reflect definitions of factoring and its forms established by new factoring law;
- after adoption of the new law on factoring Tax Code of Georgia should contain a reference on factoring as a financial service;
- Law on Licenses and Permits pursuant to which it is prohibited to introduce any licenses or permits other than those that are specifically prescribed by this Law, should regulate licensing of factoring activities;
- bylaws issued by the National Bank of Georgia in relation to accounting, classification of assets etc. of commercial banks and microfinance organizations that currently refer to factoring without defining its content, should be considered from perspective of new factoring law.

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