Kluwer Arbitration Blog

Arbitration of International Factoring Disputes: Back to the Origins

Guillermo García-Perrote (Herbert Smith Freehills LLP) and Robin Wood (Herbert Smith Freehills) ·
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Text books will tell you that, in its origins, the concept of arbitration as a method of resolving disputes was a simple one: two merchants, arguing over damaged merchandise, would settle their dispute by accepting the decision of a fellow merchant. And they would do so not because of any legal mandate, but because it was expected of them within the community in which they carried on business.

This is exactly what you can expect from this article: the arbitration of commercial disputes back to its origins. Specifically, the arbitration of disputes within the international factoring community.

The authors recently took part in an arbitration under the Rules of Arbitration of Factors Chain International (FCI Rules). In this article we share some of the lessons which we learned during the arbitration, and highlight some of the specific features of the FCI Rules which differ from the more familiar arbitral institutions.

What is factoring?

At its simplest, factoring is a transaction which enables a seller of goods to assign its receivables (generally invoices) to a third party (the factor) which, in exchange for a commission, collects the receivable and assumes the credit risk of the buyer of the goods. In other words, in exchange for the factor's commission, the seller of goods can pass on the risk of bad debts and the inconvenience of collecting and managing receivables. Factoring in this form began in the US in the mid-19th century.

By the 1960s, in order to overcome the practical challenges associated with factoring cross-border transactions, the process had evolved (led by the European market) into the more complex process of "two factor international factoring". This system of factor involves two factoring organisations: one in the country of the seller (the Export Factor) and another in the country of the buyer (the Import Factor). The advantage of a two-factor system is that each factor is familiar with the local requirements for the assignment and collection of receivables, and the Import Factor is located in the same jurisdiction as the Buyer, which is helpful in collecting the debt, especially if the Buyer defaults. This approach was reflected in the 1988 UNIDROIT Convention on International Factoring (the Ottawa Convention), which has proven to be an influential soft law mechanism to harmonise practices and regulations around the factoring industry.

In summary the process works like this:

1. The seller signs a factoring contract with the Export Factor. To avoid the risk of the seller only factoring its risky debts this frequently provides that the seller must assign all approved receivables to the Export Factor (this is referred to as the principle of globality).
2. The Export Factor selects a counter party, the Import Factor, usually in the country where the buyer is based and, under the terms of an interfactor agreement, assigns the receivables to the Import Factor.
3. The Export Factor may advance a proportion of the value of the receivable (usually up to 80%) to the seller.
4. The Import Factor collects the receivable and forwards the funds (less a commission) to the Export Factor which, in turn, deducts its commission and pays the balance to the seller.
5. The Import Factor guarantees the debt so that the seller receives payment even if the buyer fails to pay.

What is the role of FCI?

FCI is arguably the leading institution overseeing factoring and has produced a set of rules, the General Rules on International Factoring (GRIF Rules), which are used by many of the leading financial institutions.

Under the GRIF Rules the factoring companies enter into umbrella interfactor agreements and then agree individual credit lines using an electronic messaging system called edifactoring.com (governed by its own set of rules).

Factoring under the GRIF Rules is a highly commoditised process, which operates on low commissions. There are a number of standard messages (EDI messages) used to, for example, offer a new transaction, approve a credit line or confirm payment. The system is designed to cause as little friction as possible to the underlying commercial transaction.

How are disputes relating to factoring transactions resolved?

Given the commoditised nature of factoring transactions under the GRIF Rules, disputes are comparatively rare. Where such disputes do arise, it is generally because the buyer has defaulted and the Import Factor feels that the circumstances are such that it should be relieved of the obligation to pay the sums owed under the guarantee.

In this regard, the factoring transaction is similar to an insurance policy: like an insurer, the Import Factor must guarantee the buyer’s debt unless the Export Factor has failed to comply with the interfactor agreement. The GRIF Rules expressly set out the very limited circumstances in which the Import Factor will be relieved of liability – in essence, this will be the case if, either:

1. a misrepresentation or non-compliance by the Export Factor has prevented the Import Factor from properly assessing the risk it was taking on; or
2. the Export Factor has failed to assign the receivable correctly so that the Import Factor cannot collect the debt.

To resolve such disputes, FCI has produced the FCI Rules. These are designed to offer a swift, streamlined process, and are heavily focussed on delivering a commercial solution.

The arbitrations are formally seated in Amsterdam (where FCI is based) and, for disputes worth under €100,000 can be heard by a sole arbitrator. For larger disputes the FCI Rules require a tribunal of three arbitrators.

Arbitrators must be senior executives of FCI member companies (there is no requirement that they are lawyers nor that they have any dispute resolution experience) and, in the case of a three-member tribunal, the chair must be selected by the party nominated arbitrators from a list published by the FCI.

The tribunal has broad procedural discretion and, although the FCI Rules anticipate an award within three months of signature of the terms of reference, our experience has been that the FCI secretariat is quite willing to extend this period at the tribunal's request.

The arbitration process is commenced with a Request for Arbitration which must be served within three years of the events in dispute. The Respondent has 30 days to file his Response and the file is then passed to the nominated arbitrators who have a further 30 days to appoint a chairman from the FCI list.

Once constituted, the tribunal will draw up (in consultation with the parties) terms of reference which will indicate the procedure to be followed.

The process is intended to be one of commercial equity rather than the strict application of national laws and Article 18 of the FCI Rules provides that *"[t]he arbitrator shall not be bound by any strict rules of law or procedure or evidence. He shall be entitled to make his decisions in accordance with what he thinks is fair and equitable between the parties in accordance with normal commercial practice and the customs of international factoring based on the GRIF".*

From an advocate's perspective this means that a thorough understanding of the commercial dynamics at play in a factoring transaction is key. Indeed, the tribunal is going to be more interested in exploring the commercial aspects of the case than in arguments fully based on the black-letter of the GRIF Rules.

The use of the edifactoring.com messaging system also has a significant impact on the dynamics of the arbitration. Since all contractual communications happen through the messaging platform, in effect, all of the contract documents and all of the relevant facts are to be found in the EDI messages. The EDI messages themselves, however, are highly standardised, with limited scope for "free text" comment. Since the tribunal members are all senior executives within FCI member organisations, they are very familiar with the EDI messages, and advocates are expected to master the industry mechanics.

Once handed down the award is final and binding and, by Article 1(3) of the FCI Rules, the parties shall be deemed *"to have waived their right to any form of appeal or objection, whether as to procedures or otherwise, in so far as such waiver can validly be made."*

The focus on a swift and final commercial resolution of disputes with little recourse to national law is understandable in the context of a highly commoditised cross-border transaction, and it certainly provides a thrilling challenge for lawyers accustomed to arguing points of law before international arbitration tribunals made up of experienced lawyers. Advocacy is just as interesting and challenging, and the interaction with the Tribunal is even more dynamic.

For those facing the prospect of an arbitration under the FCI Rules, our advice would be to become thoroughly familiar with the commercial dynamics of the transaction and the EDI messages, and to adapt the advocacy preparations and delivery accordingly.

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