

Rules on the Certainty of Future Accounts Receivable

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Abstract

Before the enactment of the Civil Code of the People's Republic of China, the legislative recognition of future receivable factoring in China underwent a transformation from non-recognition to limited recognition only for receivable with underlying transaction relationship. Although the Civil Code acknowledges that future receivable is eligible for factoring, it does not explicitly restrict its transferability. Many foreign countries and international conventions recognize the eligibility of future receivables as factoring assets but require determinacy and certainty. The need for determinacy arises because future receivables are considered future claims therefore must meet the requirement of specific identification. In addition, to ensure the possibility of reasonable expectations for factoring parties, future receivables should be clearly identifiable. Given the fact that future receivables have yet to materialize, the concept of relative determinacy is employed to describe the degree of certainty, and the verification of the contractually agreed amount and the period when future receivables arise is adopted as the method for determination. In order to mitigate the risk of fictitious receivables arising from the lack of determinacy, the understanding of Article 763 of the Civil Code should be interpreted as "know or should have known". Factoring parties bear a reasonable duty to conduct appropriate due diligence for certainty examination and the minimum standard approach is recommended.

Keywords

Factoring; Future Accounts Receivable; Determinacy; Factor's Duty of Examination.

1. Introduction

Prior to the enactment of the Civil Code of the People's Republic of China (hereinafter referred to as the Civil Code), there had been considerable controversy in the field of judicial practice about whether future accounts receivable can be used as factoring. Article 13 of the Interim Measures for the Administration of Factoring Business of Commercial Banks (hereinafter referred to as the Measures) stipulates that commercial banks shall not engaged in factoring based on future accounts receivables that expected upon completion of the seller's obligation under the contract, which in effect denies the eligibility of using future accounts receivable as the object of commercial bank factoring. However, the Measures is only a departmental regulation issued by the former China Banking Regulatory Commission with a lower level of legal efficacy. Additionally, the regulatory purpose of the Measures is to strictly limit the use of future accounts receivable in factoring based on the principle of prudential operation of financial institutions and it does not adjust the validity of the factoring contract itself. Therefore, the validity of the transfer of future accounts receivable in factoring contracts needs to be confirmed by the judicial department. According to the Several Specific Issues of the Supreme People's Court on the Current Trials of Commercial Cases carried out in 2015, even if the future claims transferred in the factoring contract have not yet become due, they should not be denied on the grounds of the nature and validity of the factoring contract as long as the accounts receivable claims corresponding to the underlying contract exist at the time of the conclusion

of the factoring contract. In other words, the transfer of future accounts receivable with a transactional basis has validity. In subsequent adjudication, it is still necessary to determine the validity of a specific future accounts receivable factoring contract by combining the basic principles of civil law, various commercial practices and the international rules on accounts receivable transfer, especially for the transfer of future accounts receivable without a transactional basis.

The Civil Code has come into force on January 1, 2021. With a dedicated chapter on factoring contracts, it formally establishes factoring contracts as one of the nominate contracts under the contract book. Article 761 of the Civil Code recognizes the eligibility of using future accounts receivable as the object of factoring. In coordination with this, the Measures for the Unified Registration of Security Interests Over Movable Properties and Rights (hereinafter referred to as the "Unified Registration Measures") implemented by the central bank since February 2022 also acknowledges that the scope of accounts receivable rights includes not only existing but also future pecuniary claims. Under the current legal framework of China, future accounts receivable without a transactional basis can also appear as eligible contract objects in factoring business.

Although the factoring of future accounts receivable has been qualitatively improved in legislation, the current laws and regulations do not explicitly stipulate the eligibility criteria for using future accounts receivable in factoring, nor do they make clear restrictions on its transfer. In practice, a large number of disputes involving future accounts receivable factoring have emerged. Although "certainty" of accounts receivable is often taken as the considerable factor in judging the transferability of such future claims, there are differences in the methods and standards used by different courts. To illustrate, in typical cases where the transaction volume of credit receivable generated by POS machines is used as the object of factoring, judicial practice often insists on comprehensively considering the elements of basic transaction contract to determine whether a particular accounts receivable has certainty. These elements may include counterparty, subject matter, and the nature of the claim in the underlying transaction contract. What's more, it generally holds that future claims with unspecified transaction counterparties lack certainty. However, some courts have relatively loose standards for determining certainty. In the case where "all accounts receivable generated by all downstream sales customers within the next 2 years from a certain date" were used as the pledge object, the Taizhou Intermediate People's Court of Zhejiang Province held that although this accounts receivable did not have certain pledge subject matter and payment obligor, the time-limited description was sufficient to determine the certainty of the future accounts receivable.

Under the backdrop that the transferability standard of future accounts receivable is unclear, it is necessary to discuss and compare the various definitions, judgments, and examination methods of certainty in academics and judicial practice at home and abroad in order to clarify and deeply understand the connotation of the certainty of future accounts receivable.

2. The Source and Applicability of the Certainty of Future Accounts Receivable

Based on the requirement of expectability, although the future accounts receivable that serve as the subject matter of the factoring contract have not yet arisen, they will occur at some point in the future and the factor has a reasonable expectation on it. [1]

2.1. The Reasonable Expectation of the Factoring on Future Accounts Receivable

The so-called reasonable expectation means that not only are the parties able to recognize the possibility of the occurrence of future accounts receivable, but they could also foresee the risks and they reach an agreement with the relevant parties and expect the fulfillment of the accounts receivable payment conditions. The essence of the transfer of future accounts receivable is the transfer of the expectation interest. Only when the future claims have certainty can the expectation become reasonable and could the parties generate the corresponding expected interest accordingly.

In fact, the judicial practice in China has not made a clear distinction between reasonable expectation and certainty. In a POS machine factoring dispute case in Shanghai, the court held that the contract involved only made an agreement on the period of the future claims, and there was no agreement on other elements such as the contractual counterparty and subject matter. Thus, the court could not confirm that the future claim involved already had certainty and reasonable expectation interests so that could not be transferred. From the perspective of the factor, it failed to fulfill its reasonable review obligation so that the claim was not certain and therefore not reasonably expected. Instead of factoring, such a transfer of future accounts receivable was in fact a loan. In short, the court believed that the fundamental problem of the non-transferability of the claim was that it is short of reasonable expectation, and the main basis for the lack of expectation was that it did not meet the requirement of certainty. Therefore, in order to make the factor's expectation interest become reasonable, a certain degree of certainty is necessary.

2.2. Application of the Specific Claim Rule to the Future Accounts Receivable

The transfer of claims is essentially a disposition of rights. The so-called specificity of claims means that before disposing of the rights, the rights must be determinable and the parties need to be able to accurately describe the objects of the assigned claims so that they can be effectively distinguished from the other property of the debtor. [2] Theoretically, future claims can be divided into claims with a transactional basis and claims without a transactional basis. The former includes claims subject to conditions or terms while the latter refers to purely future claims that do not have any legal basis at the time of the claim transfer, such as claims arising from future sales, leases, service contracts and so on. In the former case, once the contract is established, the characteristics of the claim can be determined according to the contract provisions and the claim is generally presumed to meet the requirement of claim specificity unless there is contrary evidence. Whereas the lack of a transactional basis makes the identification of specificity of the latter more complicated.

The accounting term "receivable" is transformed into civil law term in accordance with the Article 3 of the Uniform Registration Measures as "a claim with pecuniary payment based on contract". Article 769 of the Civil Code also provides that the rules relating to the assignment of claims shall apply if the factoring contracts chapter is silence. Therefore, the object of the factoring contract should be defined as a pecuniary claim arising from the contract and there is a "special and general" relationship between them, i.e., the future accounts receivable is a form of future claim. [3]

Under a non-notification factoring, the unrestricted circulation of receivables as unspecified claims can result in the inability of the successor to assert its rights against its prior parties and the original counterparty. It is highly likely that such financial products will enter the market through some financial means like asset securitization, generating a financial multiplier effect and thus triggering systemic financial risks.

Based on this "special and general" relationship and its financial-commercial attribute, the future accounts receivable should also meet the standard of the specificity of claims to the extent that it could be determined and identifiable.

2.3. Bottlenecks in the Application of the Rule of Certainty

Applying the claim-specificity and expectability requirements to the factoring of future accounts receivable, it requires that the future accounts receivable should be identifiable and certain as a claim covered under the assignment contract at the time the future claim actually arises or it cannot be assigned. This requirement of certainty is often externalized in different ways in the legislation and judicial practice of various countries. For example, although the UK common law does not recognize that property does not yet exist could be transferred, the law of equity as a supplementary system for the defects of the common law rules considers that a claim which would be consummated in the future is a consummated claim. The transfer of a future claim is allowed as long as it can be sufficiently identified under the contract. [4] The Uniform Commercial Code of the USA takes a more positive approach to the factoring of future claims than the UK. Article 9-204 providing that rights may be created in subsequently acquired collateral and that property relating to future financing may be transferred in a security agreement as long as the future receivable is stated with certainty in the agreement for the assignment. [5] In Japan, while acknowledges the factoring of future receivable in its civil code, the recent judicial precedents hold that future claims are supposed to be adequately identified under the assignment agreement. Academic views also hold that it is necessary to restrict future claims in terms of cause, type, period and the amount of the claim, etc. [6] The traditional view of the German civil law holds that the assignment of claims is subject to the principle of certainty. Although the law does not expressly provide for the assignability of future claims, German courts have, from an economic and practical point of view, held that it is sufficient if the claim is "certain" or "identifiable" when it arises in the future.

In the face of factoring of future accounts receivable without transactional basis, the concept of "certainty" is also adopted by most Chinese practices to judge whether a particular receivable will be transferable, which to a certain extent makes up for the inadequacy of the legislation in the issue of the criteria for suitable receivables. However, the certainty examination has not become the necessary step in the review of transferability. Secondly, even if certainty is partially adopted as the criterion for transferability, systematic criteria and review methods haven't been formed. These all make different judgements in similar cases frequently occur.

In comparison, most of the international conventions on factoring and assignment of accounts receivable issued at present stipulate the transferability standard while clearly clarifying the eligibility of future accounts receivable. Article 5 of the UNIDROIT Convention on International Factoring clearly clarifies the validity of the assignment of claims on future receivables and requires that such receivables can be identified to the contract at the time of its conclusion or when they come into existence, i.e., it requires that the future receivables should have the character of certainty. The United Nations Convention on the Assignment of Receivables in International Trade takes a position similar to that of the UNIDROIT Convention on International Factoring, recognizing future receivables as eligible factoring objects and requiring certainty as a criterion for their assignability. Its Article 8 provides that the future receivables should be identified as receivables to the contract that the assignment relates. The recent Model Law of Factoring also recognizes the eligibility of future receivables but at the same time it provides that an assignment is effective only if the transferor acquires right in the corresponding receivable and shall not assign a fictitious right to another person.

Under the international integration process of factoring business, Chinese legislation also take the trend of expanding the scope of factoring objects. Therefore, it is necessary to take certainty as the transferability requirement for future accounts receivable factoring and systemize and

regularize the methods of certainty examination referring to the practice of various countries and international conventions.

3. The Concept of Relative Certainty and Its Examination Methods

The so-called certainty of a receivable means that at the time the receivable arises, it can be directly identified as belonging to the scope of the claims assigned by the factoring contract, with elements such as the identification of the counterparty, the subject matter of the transaction, the amount of the receivable, the source of repayment, the period of repayment and so on. However, since the future receivable is not actually created, it is clearly not in line with the practical requirements to ask it to have the same level of certainty as the existing one.

3.1. Degree of Certainty and the Concept of Relative Certainty

It is generally agreed that in the case of an assignment of receivables with transactional basis, once the underlying transactional contract has been established, the interests of the counterparties are fixed on the expectancy of benefits. The characteristics of the receivable can be determined on the basis of the content of the contractual agreement, which in principle meets the requirement of certainty if there is no contrary evidence. [7] As for the future receivables without the underlying transactional relationship, academics often use the concept of "relative certainty" to describe the degree of certainty that will be available to the receivables, only requiring it to generally reach the degree of being able to be identified and recognized.

Compared with the former one, the "relative certainty" judgement method of receivables without transactional basis is obviously more complicated. Not only does it need to identify the main elements of receivables, but it also needs to take into account the special characteristic of the future accounts receivable that it has not happened yet. According to that, the academics has proposed a number of ways of certainty examination.

3.2. Several Ways of Certainty Examination

3.2.1. Determined by Specific Terms

In this approach, it is only necessary to judge whether the future receivable will occur in a particular period of time or range of amount. If that is the case, it is considered to have relative certainty. However, there are certain problems with this method. Different factors like the cause, the type and other elements of the debt will lead to different dimensions of time and amount. In other words, the standard derived from one case cannot be universally applied to other specific cases. The standard of certainty of accounts receivable where the underlying legal relationship is a contract of sale is inevitably different from the standard where the underlying legal relationship is a contract of service. Such an approach would indeed be difficult to reconcile with the inevitable expanding and updating trends of accounts receivable factoring.

3.2.2. Flexible Systems Approach

In this way, a comprehensive judgement is made on multiple elements such as the specific cause, amount, duration, creditor, debtor, time of the claim, etc. If the selection and combination of the elements reaches a certain level and satisfy a certain standard, the future receivable will be seemed as having a high possibility of occurrence even if some elements are missing. [8]

Scholars who support this model believe that it gives up the all-or-nothing judgement of constituent elements and turns to focus on the combination of legal elements and the evaluation of the magnitude of the impact to judge the specificity of the future claim, solving the drawbacks of the first method which is unable to be quantified and standardized. However, many scholars are opposed to such a review method which is based on the early Japanese future receivables factoring. They believe that the essence of the flexible system theory is that receivables with a high possibility of occurrence can be regarded as the eligible object. However, as the new

Japanese academic view, the alienation of future claims is in principle possible regardless of the likelihood of occurrence. In addition, the opposing view holds that when applying the flexible system approach, factors other than the period of time during which the claim arose are judged by the so-called "impact" "degree" and "size" of the claim, but there is actually no such a unified thing of "size" "impact" and "degree". It would not be definitive and would further exacerbate the difficulty of determining certainty and there is often a hidden danger of arbitrary behind the flexibility. [9]

3.2.3. Factoring Contract Review: Credit Limit + Period of Generation

Some scholars argue that the judgement of certainty can be achieved by verification of the factoring contract. In this method, the examination of the factoring contract focuses on the verification of the credit limit and the period during which the receivables will arise. In the case of credit limits, the factor and the original creditor define a range of permissible financing limits, within which receivables can be assigned to the factor as long as they can be considered to fall when they actually arise. As for the period of generation, an important reference for the specification of future claims is that they are confined to a specific period of time. The factor and the original creditor agree on a period of time during which the receivables arising from the specific period are to be considered as receivables under the contract. [10]

3.3. The Final Choice of Methods above

Comparing three review methods above, the third method is more adaptable to the factoring of future accounts receivable for its considerable operability. Firstly, the factoring contract is an agreement reached between the creditor and the factor based on their own experience and risk judgment after reasonable review obligation. The examination of factoring contracts can not only ensure the comprehensiveness of the examination to a certain extent, but also respect the autonomy of the parties to the greatest extent. Secondly, due to the fact that the factoring contract is a special formed contract, the verification of contractual matters is considerably practical. As mentioned above, the American guarantee law practice recognizes that the scope of the property clearly written in the guarantee agreement could assist in the establishment of rights on the property acquired in the future. Its civil law viewpoints also agree that it is sufficient for the assignment agreement to contain a clear scope of the assignment of the future claims.

Reviewing the agreed credit limit and the agreed period of generation is essentially a method to examine the certainty from two main dimensions of space and time. Compared with the previous two review methods, it is simpler, clearer and more practical. This relatively loose review method can ensure the "certainty" while retaining the flexibility of the "relative certainty" of the future receivables, which is more in line with China's recent judicial practice.

4. Based on the Requirement of Certainty Factors Have an Obligation of Examination

As the object of factoring, the future receivable should meet the requirement of relative certainty. The lack of certainty will lead to a substantial increase in the risk of fabricated future receivable because the future receivable is more risky and speculative than the existing receivable. As an astute businessman, the factor should take the responsibility to properly examine the business status, credit risks and transaction documents of the assignor and the debtor before entering into a contract in order to ensure that the receivable subsequently acquired by the original creditor can be identified and determined, making risk assessment and control measures with respect to all matters of the contractual future receivable.

4.1. Article 763 of the Civil Code–Factor’s Obligation of Examination

The rule of assuming liability for fabricated receivable in factoring is clarified by the Article 763 of the Civil Code. From the provision itself, it seems that the word "know" exempts the factor from all examination obligations, i.e., debtor is not allowed to defend as long as the factor does not actually know the receivables are fabricated. The relevant provisions of the German Civil Code, which uses the wording of "know or should have known". The "know" here refers to the factor knows that the receivables are fabricated while the "should have known" means that the factor should have known but fails to discover intentionally or with gross negligence. It is believed that the "know" in the Article 763 of the Civil Code should be interpreted as the term "know or should have known" and here are three reasons for the understanding.

Firstly, the legislator hopes that this proviso will make it clear that the factor needs to undertake an appropriate duty of review while protecting the reasonable expectations of the factor and curbing the increasingly rampant factoring fraud. In the context of Article 763, the validity of fabricated receivables comes from the factor’s reasonable expectation and the fabricated receivables are deemed to satisfy the certainty requirement. However, the literal interpretation of Article 763 which means that the factor could establish reasonable expectation without any examination and risk judgement which would clearly be contrary to the purpose of the legislation.

Secondly, from perspective of the debtor, the literal interpretation will lead to an inappropriate expansion of the debtor's liability and break the balance of the interests of different parties, which is obviously not in line with the basic principles of civil law of equality and fairness.

Thirdly, factor may be involved in fabricated future accounts receivable. If the factor can confirm the validity the objects of the factoring contract by relying only on the appearance of the commercial transaction, it will lead to the behavior that is actually a loan being disguised with an appearance of a legitimate factoring. [11] Instead of favoring the equilibrium of interests between the parties, it may lead to a proliferation of related cases and an unnecessary increase in judicial costs.

Therefore, the wording "know" in Article 763 of the Civil Code should be expanded to include the meaning of "should have known", imposing an appropriate and necessary obligation of examination on the factor.

4.2. Ways for Examination and the Boundary of Responsibility

The academics tends to have three different views on the way in which the factor's review is conducted.

The formal review theory holds that the factor should only be required to do what an ordinary person would do to verify the underlying transaction contract and the confirmation of claims. It should not be required to conduct a substantial review or even an on-site investigation of all the transaction documents. This view holds that the factor is not a professional operator in the transactional industry, and its cost of discovering fabricated receivables is higher than the cost of the assignor and debtor conspired to make fabricated receivables. The increase of the factor's operation cost will be directly reflected in the transaction method and transaction price of receivable financing, which will then have a negative impact on the factoring industry.

The substantial review theory holds that in addition to the formal review, the factor should conduct substantive review of the real trading behaviors of both parties of the transaction. It is clearly stipulated in the Administrative Measures that the factor shall conduct effective due diligence to on clients, transactions and other relevant aspects, lay emphasis on counterparties, goods, and trade usage, examine the original documents or the electronic trading information recognized by the bank to confirm the authenticity and reasonability of the relevant trading behavior.

Some other scholars believe that the above two one-size-fits-all methods should be replaced by some "minimum standards" methods, which is proposed for specific review procedures and different situations. If the factor can prove that its verification behaviour is higher than the "minimum standards", then it should be considered that it has done its due diligence. In judicial practice, it is often believed that a factor can be considered to have properly fulfilled its review obligation by taking the following two measures. First, the factor traces the relevant sales contracts, invoices and other original documents from the accounting books. Second, the factor compares the confirmation of assignment of accounts receivable received with the notification of assignment of accounts receivable to examine whether the two records are in compliance with each other. The third review method is that these two measures should be taken as the basic elements of the "minimum standard", and different elements should be adopted for different factoring methods. In the case of notification factoring where the factor notifies the buyer, only the consistency between the confirmation and the notification should be examined. In the case of non-notification factoring and notification factoring where the buyer is not notified by the factor, emphasis should be placed on the examination of the seller's credit and operation status facing the future accounts receivable without transactional basis. As for the future receivables with transactional basis however the obligations of the seller not yet fulfilled, emphasis should be placed on the verification of the underlying contract and original documents throughout the transaction. When it comes to receivables with basis and only the payment terms have not been reached, the original documents related to revenue recognition should be traced from the contractual assets recognized by the seller. [12]

If the formal review method is adopted, it would undoubtedly create greater uncertainty for future receivable factoring which is more speculative and risky than the existing one. If substantive review method is adopted, the factor is faced with the problem of how to strictly examine the non-existent transactions and assets and that would add an excessive burden on it. The third type of review method takes into account the fact that there are different types and sections of future receivable factoring. It analyses specific issues and takes the "minimum standard" under different scenarios as the bottom line of the factor's review obligation, which more ideally achieves the marginal balance between the necessity of the examination obligation and the appropriateness of the degree of review.

5. Conclusion

Accounts receivable financing has been legally recognized by most countries in the world for its strong economic value. At present, although China has adopted the legislative trend of expanding the scope of factoring objects in line with international convergence, it has not clarified the restrictive conditions for the future receivable assignment, leaving considerable space for interpretation.

In order to effectively regulate the financing of future receivable, reference should be made to the practice of foreign countries and international conventions to take relative certainty as a limiting condition for the assignment. To examine the certainty of the receivables, elements such as the credit limit and the period of time during which the receivables are to be generated in the factoring contract should be taken into account. For the risk of fabricated future receivable caused by the lack of certainty, the wording "know" in Article 763 of the Civil Code should be expansively interpreted as "know or should have known" to make it clear that the factors have an appropriate duty of examination so as to prevent factoring fraud and protect the balance of rights and obligations in the multi-party relationships.

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