Prohibitions on Assignment of Receivables – Outlawed

Why?

The government recognises that businesses are dependent on adequate cash flow and that invoice finance is an important way of securing such working capital. Currently, around 40,000 firms in the UK use invoice finance. This is estimated to be only 10% of the number of businesses that could potentially make use of it[1]. Currently £311 billion[2] (14% of UK's GDP) is supported through invoice finance.

Assignments of receivables are an essential feature of factoring and invoice discounting. Commercial contracts routinely contain provisions that prohibit the assignment of invoices due under the contract. If asked to fund such invoices, financiers have to use work-arounds, such as requesting the debtor to allow assignment (which is usually refused) or using a separate trust account or a power of attorney. This increases the cost of providing invoice finance and, if the measures are not cost effective, then a facility will be refused or the funds available substantially reduced.

For years, powerful purchasers have flouted the credit terms of their weaker SME suppliers or imposed unreasonable credit terms on them[3]. If invoice finance is then provided, such purchasers often refuse to deal with the financier by contractually inserting in their purchase conditions either a prohibition on assignment of the invoices or confidentiality terms. Such prohibitions and terms reflect the purchasers' resentment of the collective commercial clout and professional expertise of invoice financiers.

The Act

In 2014 the Government recognised the benefit of outlawing such prohibitions on the assignment of receivables and set about establishing the legal framework. The Asset Based Finance Association (ABFA) was approached and with our help formulated the provisions for a new law.

The outcome was a clear provision in the *Small Business, Enterprise and Employment Act 2015* (Act) allowing regulations to be made to *"invalidate certain restrictive terms of business contracts"*[4]. These regulations have now been drafted and await Parliamentary approval.

The new law will apply to SME suppliers, but only in B2B agreements.

1 See paragraph 7.2 of BEIS Memorandum about the Regulations at https://www.legislation.gov.uk/ukdsi/2017/9780111160305/pdfs/ukdsiem_9780111160305_en.pdf.

2 Source UK Finance statistics.

3 The government estimates this affects 85% of small businesses. See paragraph 6 the Explanatory Notes to the Act at https://www.legislation.gov.uk/ukdsi/2017/9780111160305/pdfs/ukdsiem_9780111160305_en.pdf.

4 Section 1 of the Act.

The Regulations

These are *The Business Contract (Assignment of Receivables) Regulations* 2018. These have been under discussion for the past three years with the Dept. of Business, Energy and Industrial Strategy (BEIS), where ABFA (now part of UK Finance) and Edward Wilde, as their legal counsel, have negotiated and redrafted the wording to ensure the best possible outcome for invoice financiers and their SME clients. This was undertaken in the face of strong opposition from City of London interests determined to preserve their unfettered freedom to contract as they wished.

The finally agreed regulations should be law in the autumn and come into effect for sales contracts entered into on and after 31 December 2018.

"Receivable"

This word enters our legislation for the first time, to replace the more familiar usage of "book debt" and "debt". Using current language from US, Canadian and Australian laws, the full definition is:

> *""receivable" is a right (whether or not earned by performance) to be paid any amount under a contract (other than a contract mentioned in regulation 4) for the supply of goods, services or intangible assets*[5]*…"*

Basic Outlawing of Prohibitions

The Regulations boldly state[6] that:

> a term in a contract has no effect to the extent that it *"prohibits or imposes a condition or other restriction on the assignment of a receivable arising under that contract or any other contract between the same parties"*.

Additional Protection for Invoice Financiers

Anti-avoidance regulations, drafted and promoted by Squire Patton Boggs lawyers, extend the restraining provisions so that a contractual term (such as a confidentiality clause) is ineffective if it:

- "prevents a person to whom a receivable is assigned (i.e. the invoice financier) from determining the validity or value of the receivable or their ability to enforce the receivable;
- hinders the assignee's ability to enforce the receivable[7]."

These should prevent confidentiality clauses and other devices being used to obstruct an invoice financier from approving, funding or collecting a receivable.

5 Regulation 1(3).

6 Regulation 2(1).

7 Regulations 2(2) and 2(3).

The regulations contain a list of matters that an assignee must be able to obtain without, in effect, breaching any confidentiality clause imposed on the client. They include details of the debtor, the goods, the invoice value, the wording of any ban on assignments, VAT, credit period and defences or set-offs[8].

Assignment

This all important term is not defined, but the regulations are clearly intended to apply to outright purchases under invoice financing facilities. Security assignments are also likely to be covered. However, prohibitions against trusts of receivables will probably still be effective.

Excluded Receivables

Receivables arising under certain types of contracts, listed in regulation 4, will still be subject to effective prohibitions on assignment. The most important are contracts:

- concerning any interest in land, e.g. sales or leases
- where none of the parties are carrying on a business in the UK
- which concern national security interests
- for the sale of a business
- for operating leases of equipment

Supplier Must Be an SME

To benefit from the regulations, the supplier must be below the medium sized thresholds enabling it to take advantage of the special accounting regimes applicable to SMEs under the Companies Act 2006[9]. A medium sized company or LLP by this definition must have at least two out of three of the following:

- Sales less than £36 million
- Balance sheet total less than £18 million
- Fewer than 250 employees

Certain companies, even though medium sized, are precluded from this definition[10], including:

- Public listed company
- Insurance company
- Subsidiary company or an associated company of a company listed in the Stock Exchange
- PLC

There are complex provisions in the regulations which deny some SMEs the benefit of the regulations even though they are SMEs. So bans on assignment will still be effective if the supplier is part of a large group of connected businesses[11] that, together, exceed the above thresholds. KYC on this aspect of a client will be very important to ensure that a client which is an apparent SME is not actually part of a large group and thus subject to effective bans on assignment.

The SME test applies to LLPs and companies wherever in the world they are established or incorporated, provided they would qualify as SMEs if incorporated in the UK.

Sole traders, unlimited partnerships or unlimited companies, wherever established, can ignore bans on assignment, whatever their turnover, balance sheet or employees.

Special Purpose Vehicles, however small, will always be subject to effective bans on assignment.

When to Determine if Supplier Is an SME

At the time the receivable is assigned, which for all practical purposes will be when the receivable is created. Whole turnover assignments in master agreements should be treated only as agreements to assign.

How to Determine if Supplier Is an SME

Look at its status as shown in its accounts for the last financial year before the receivable is assigned. A check also needs to be made to ensure that it is not part of a large group. A new firm can be treated as an SME until it files its first set of accounts, unless it is a member of a large group. Checks will need to be done annually upon receipt of clients' accounts.

Applicable Law

The regulations generally apply to contracts governed by English or Northern Irish law where one of the parties carries on business in the UK. Clients' sale contracts subject to Scots law are not covered. However, it is to be hoped that similar rules will be passed in Scotland in due course[12].

Conversely, the regulations do not generally apply to contracts governed by foreign laws. However, there is an anti-avoidance provision[13] which outlaws any attempt to circumvent the regulations by choosing a foreign law which permits bans on assignment. For example, a sale contract generally governed by English law, but with an assignment prohibition specifically subject to Irish law (where bans on assignment are still permitted) will still be treated as being subject to the regulations.

Government Contracts and National Security

Because of the legal doctrine of Crown Immunity, neither the Act nor the Regulations apply to UK central government ministries and departments, which will still be able to impose effective prohibitions. However, suppliers should be aware when negotiating government contracts that such prohibitions have long been discouraged. In 2008 Edward Wilde, on behalf of ABFA, negotiated a protocol with the Office of Government Commerce (OGC) which led to OGC's Procurement Policy Note 07/08[14]. This explicitly changed government policy to permit the assignment of debts and rewrote OGC's model terms and conditions.

8 Regulation 2(3).
9 See sections 465 to 467 Companies Act 2006.
10 See section 467 Companies Act 2006.
11 See regulation 3(2).

12 See section 7(4) of the *Moveable Transactions (Scotland) Bill* drafted by the Scottish Law Commission for consultation.
13 Regulation 1(3).
14 07/08 of 16 June 2008 of OGC.

This helpful relaxation is now subject to the new regulations which will effectively allow prohibitions where the contract "concerns national security interests[15]". This phrase is not defined, but will be subject to a conclusive certificate from the Secretary of State at BEIS. However, it is clear from other legislation that national security is a wide ranging concept and not just limited to defence matters. Thus, a sale between a main defence contractor and its subcontractor could be subject to an effective prohibition.

After Start Date

As soon as Parliament approves the Regulations they will become effective for all new sales contracts entered into by suppliers on or after 31 December 2018. Prohibitions in existing contracts will remain effective. The position under existing long term contracts with call off provisions will need careful consideration, particularly if there is no "cut-off clause" providing for each delivery to be a separate contract. It will then be safest to treat such master prohibitions as effective and attempt the usual work rounds as at present.

Audits and Surveys

It will still be necessary for invoice financiers to check their clients' sales contracts for prohibitions. These will still be effective if:

- Scots law applies (until a change in Scots law) to the sale contract
- neither the debtor nor the client carry on business in the UK even though they have chosen English law
- the contract is an excluded contract, as listed above
- the contract is with a UK Government ministry or department
- the client and the debtor have a contract affecting national security interests

Finally

These regulations are complex and this note cannot go into all the detail. Advice should always be taken on any issues arising. In particular, additional warranties and undertakings should be inserted into master agreements with clients.

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15 Regulation 1(2)(e).