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DEBT FACTORING IN NIGERIA:

STRUCTURING, LEGAL AND REGULATORY FRAMEWORK, AND KEY CONSIDERATIONS

Introduction

The increasing globalisation of the world's economy and the demand and supply of capital have impacted how businesses operate in today's market to leverage and unlock the use of scarce resources. Businesses need capital to sustain and upscale their operations to meet the increasing demand for goods and services. In view of the decentralisation of financing, which is a byproduct of globalisation, new modes of financing for business and trades have emerged. One of such increasing new means of financing is debt factoring. Debt factoring is, simply put, the sale of receivables (debt) by one entity (the "Seller") due from another party (the "Debtor") to a third party (related or unrelated) (known as the "Factor" or "Purchaser") at a discounted price for immediate cash. In most cases, upon assigning the receivables to the Purchaser, the Seller will be required to give notice of the assignment to the Debtor. Consequently, having purchased the receivables from the Seller, the Factor will then proceed against the "Debtor" to recover the receivables. Under such an arrangement, the Factor's profit is the discount on the receivables.

Debt factoring has gained global recognition as a financing mechanism because it helps with improving a company's cash flows and enhanced credit management. It also enables a company to have increased competitiveness in the global marketplace, especially in structured trade finance. In Nigeria, for instance, the Central Bank of Nigeria ("CBN") recognises debt factoring as one of the permissible activities of finance companies and the Nigerian Export Promotion Council ("NEPC") has also introduced factoring and forfaiting as instruments for the financing of export and trade to boost the volumes of export from the country. In that regard, the NEPC provides up to USD1 billion financing for Micro, Small and Medium Enterprises on an annual basis.[1]

[1] Factor Chain International, *NEPC adopts factoring for export*, (Nov.10, 2021), https://fci.nl/en/news/nepc-adopts-factoring-export?language_content_entity=en (last visited: Feb. 6, 2022)

Debt factoring is at its early growth stage in Nigeria and Africa. In 2018, the African Development Bank and African Export-Import Bank created a fund to finance the capacity building of selected factoring firms, the advisory support among established factoring firms, as well as the development of a sustainable research, knowledge, and learning platform to support factoring in Africa.[2]

We will discuss in this publication the legal and regulatory framework for debt factoring in Nigeria, how debt factoring can be optimally structured and the relevant documentation involved, key considerations, possible risks that may arise, and ways in which such risks could be mitigated.

Legal and Regulatory Framework for Debt Factoring in Nigeria

As indicated above, debt factoring is still at its early development stage in Nigeria. At the time of this publication, there is no unified legal and regulatory framework for debt factoring in the country. The African Export-Import Bank, Nigerian Export-Import Bank, the Factor Chain International, and the Nigerian Factoring Working Group (the "Group") are currently working with the relevant regulators in Nigeria to deepen the market and ensure that there is a regulatory framework for debt factoring in Nigeria. On this basis, the Group has been promoting the Factoring Assignments (Establishment, Etc.) Bill (the "**Bill**") at the National Assembly for its enactment into law.[3] The Bill seeks to create a regulatory framework that would facilitate the development of debt factoring as an alternative means of financing for domestic and international trades in Nigeria and to provide an enabling environment for it to thrive.

The Bill makes provisions for, among other things, a factoring contract between the Seller (described as the "Client" in the Bill) and the Factor, sets out the relationship between the creditor and the Factor, and the rights and obligations of the creditor, the Factor, and the Debtor. The Bill specifically provides that a sale of trade receivables to a Factor is valid, notwithstanding a provision in the supply contract prohibiting such a sale, thus recognising the legality and enforceability of debt factoring in trade financing in Nigeria irrespective of a provision in the underlying contract prohibiting such an assignment.

Currently, with respect to entities involved in debt factoring as a business, the CBN assumes regulatory oversight over the provision of debt factoring services as a business by financial institutions in Nigeria. In this regard, the Banks and Other Financial Institutions Act 2020 (the "BOFIA") recognises the business of debt factoring as one of the permissible businesses that Nigerian banks and other financial institutions can carry out in Nigeria.[4] The BOFIA defines factoring as the business of acquiring debts due to any person.

Additionally, the CBN has earlier, pursuant to the Revised Guidelines for Finance Companies in Nigeria 2014 (the "Guidelines"), provided that a finance company can be engaged in the business of debt factoring as one of its permissible businesses. The CBN, therefore, defines debt factoring in the Guidelines as the business of purchasing debts from clients at a discount and making a profit from the collection of such debts.

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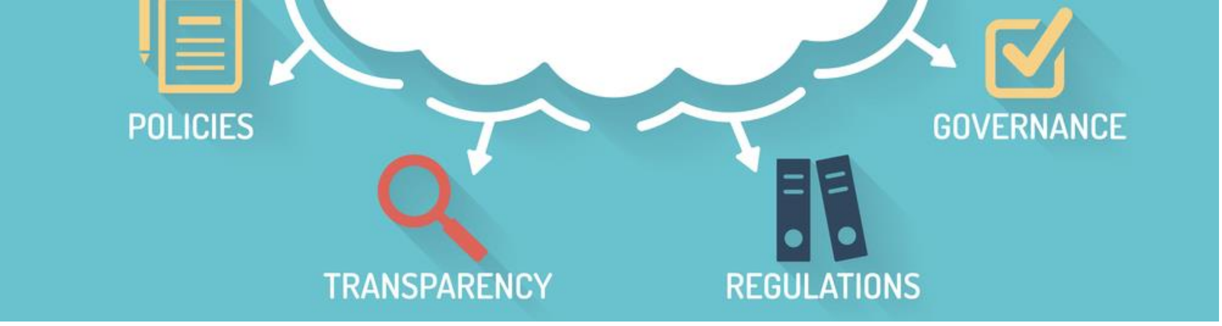
[2] African Development Bank Group, *African Development Bank and AfreximBank sign Strategic Factoring project to support African SMEs*, (Jul. 18, 2018), https://www.afdb.org/en/news-and-events/african-development-bank-and-afreximbank-sign-strategic-factoring-project-to-support-african-smes-18324 (last visited: Feb.4, 2022)
[3] Factor Chain International, *FCI Annual Review 2021*, https://fci.nl/en/media/28475/download (last visited: Feb. 3, 2022)
[4] Section 19 of BOFIA



The combined effect of the above provisions of the BOFIA and the Guidelines is that only a company that is licenced by the CBN can carry out debt factoring as one of its businesses in Nigeria. This requirement will not affect companies which do not have factoring as one of its objects but only seek to carry it out on a one-off basis. The same would, in our opinion, be true for offshore companies that seek to purchase receivables from counterparties in Nigeria and do not wish to set up debt factoring business in Nigeria.

Types of Debt Factoring

According to Factors Chain International, despite the economic effects of the Covid-19 pandemic, debt factoring activities have continued to grow in Africa. In fact, in 2020, the value of debt factoring deals in Africa was about €25 billion, representing a 2.8% increase from the 2019 value of about €24 billion.[5] Debt factoring is expected to become one of the key funding mechanisms to be adopted by companies in Nigeria in the coming years as they seek more avenues to unlock cashflows. It is in recognition of this fact that the Nigerian Senate approved the Bill in February 2021 to provide a legal framework for factoring in Nigeria.

Factoring, currently, is simply a contractual arrangement between the parties involved and it is guided by the general principles that guide contractual relationships. As a result, factoring can take different forms and it is in recognition of this that we have set out below some of the types of factoring which we have seen parties adopt today. The types include:

(a) Recourse and Non-Recourse Factoring

Recourse and non-recourse factoring are the two most common types of factoring which we have seen parties adopt in Nigeria.

Recourse factoring means that the Seller, and not the Factor, will be responsible for bearing the credit risk of the Debtor should the debt remain outstanding past the due date. In this case, some form of personal guarantee from the Seller's management will be required since the Seller will be ultimately liable should the Debtor fail to make the required payment as and at when due. This type of factoring is characterised by the Factor offering high advances and lower factor fees when purchasing the receivables from the Seller.

Non-Recourse factoring, on the other hand, involves the factor bearing the credit risk where the debt remains outstanding past the due date. This type of factoring is particularly attractive to Sellers because as long as its receivables/invoices are factored, it will get paid by the Factor, thus eliminating the uncertainty of not knowing whether or not the Debtor will (or has the ability to) pay. This type of factoring is characterised by the Factor offering lower advances and higher factor fees when purchasing the receivables, and the relevant Debtor(s) whose invoices are to be purchased would usually have a strong history of making payments as well as be capable of meeting any other requirements or qualifications which the Factor may impose.

[5] Factor Chain International, *NEPC adopts factoring for export*, (Nov.10, 2021), https://fci.nl/en/news/nepc-adopts-factoring-export?language_content_entity=en (last visited: Feb. 6, 2022)

UDO UDOMA & BELO-OSAGIE

(b) Domestic and Non-Domestic Factoring

As the name implies, domestic factoring occurs where the three parties (Factor, Seller, and Debtor) all reside in the same country. It involves the Factor purchasing, managing, funding, and collecting the receivables.

Where the above-mentioned services are provided in international markets on a cross-border basis, it is referred to as cross-border factoring. Under this factoring arrangement, one or more of the parties will be resident in a different jurisdiction.

(c) Disclosed and Undisclosed Factoring

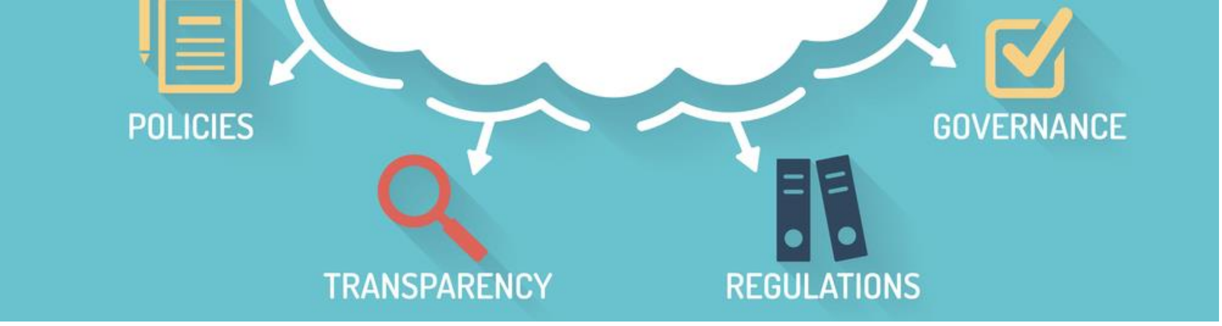
Upon purchasing receivables from a Seller, the Seller may or may not disclose to a Debtor that the receivables due from it have been sold to a third party – the Factor. Disclosed factoring involves a structure through which the existence of the factoring arrangement is disclosed to the Debtor. For example, the Seller may indicate the Factor's name on invoices sent to a Debtor, and then ask the Debtor to make payments directly to the Factor. This would create a contractual relationship between the Factor and the Debtor, and the Factor will be able to enforce (in its name without the Seller) the terms of the underlying contract against the Debtor to recover the debt. In addition, the Factor will also have priority in respect of receiving payments from the Debtor should the Seller assign the same receivables to another party.

Undisclosed factoring is, on the other hand, a factoring structure under which the Seller does not disclose the factoring arrangement to the Debtor. In this scenario, the Factor realises the debt through the Seller who continues to receive payment from the Debtor for transfer to the Factor while maintaining control over the receivables. The Factor would usually, in this case, appoint the Seller to act as its agent to recover the debt. Given that notice of the assignment of the receivables was not issued to the Debtor, there will be no contractual relationship between the Factor and the Debtor, and the Factor will only be able to enforce the terms of the underlying contract against the Debtor to recover the debt in the name of the Seller. Furthermore, the Factor will lose priority in respect of receiving payments from the Debtor should the Seller assign the same receivables to another party.

(d) Advance and Maturity Factoring

As the name implies, advance factoring is a type of factoring under which the Factor gives the Seller an advance on the uncollected receivables. Once a Seller's invoices are factored, under this arrangement, the invoice amount (less the applicable commission and the margin) are paid to the Seller. The margin will be paid post realisation of the money from the customers.

On the other hand, maturity factoring is a type of factoring under which the Factor does not give an advance to the Seller. Instead, the invoiced amount is only paid after the Debtor has settled it. In this case, the Factor is responsible for collecting the receivables from the Debtors.



Looking at the above types of factoring, choosing the most suitable factoring type or structure for a business is largely dependent on a number of factors. Such factors would include the creditworthiness of the Debtors, how much cash the Seller needs at the relevant time, the strength of the Seller's balance sheets and the fees and expenses to be incurred for utilising the services of a Factor. Thus, it is vital that business owners examine the pros and cons of each structure or type before deciding to engage in a factoring arrangement.

Documentation

The principal agreement in which the terms of a factoring transaction are set out is either a factoring contract as prescribed in the Bill or a deed of assignment of receivables which is based on the agreement of the parties. If the Bill becomes law, a "Factoring Contract" would mean a contract concluded between a client and a Factor pursuant to which the client assigns, will assign, or will offer to assign, to the Factor trade receivables arising from supply contracts between the client and its Debtors; and the Factor is to perform at least one of the following functions:

(i) providing or procuring finance for the client, including loans and advance payments that are directly related to the value of each trade receivable and its perceived credit risk at the time the receivable is created or at any time thereafter;

(ii) maintenance of accounts (ledgering) relating to the assigned receivables; or

(iii) collection of assigned receivables.

The contract will also provide that, unless otherwise agreed, any collection by a Factor is for its own account and not as agent for the client and any collection made by the client for the benefit of the Factor is deemed to be made by the factor. Other terms would include protection against default in payment by debtors solely because of their financial inability to pay may or may not be given and notice of the assignment of the receivables may or may not be given to debtors.

Terms similar to the above are usually contained in deeds for the assignment of receivables and other general terms which the parties may agree to in the document including passing of risk and the giving of notice.

Generally, certain clauses must be present in every factoring contract and these clauses include:

(a) Advance Fee Clause

This is a very important clause as the advance fee usually forms the basis for entering into the agreement in the first place. The advance fee is part of the invoiced amount that a Seller will pay upon signing the factoring contract.

(b) Termination Clause

When a Seller decides to end a factoring contract, there is usually a termination fee payable to the Factor, usually a percentage of the credit line from the Factor. The fee to be paid varies and depends on the terms agreed to by the parties.

(c) Commission and Fees

This clause provides the percentage of the receivables the Factor will be allowed to take a commission for providing debt factoring services. Provision may also be made to cover monthly or weekly maintenance fees on the factoring contract.

(d) Non-approved Accounts and Disputes

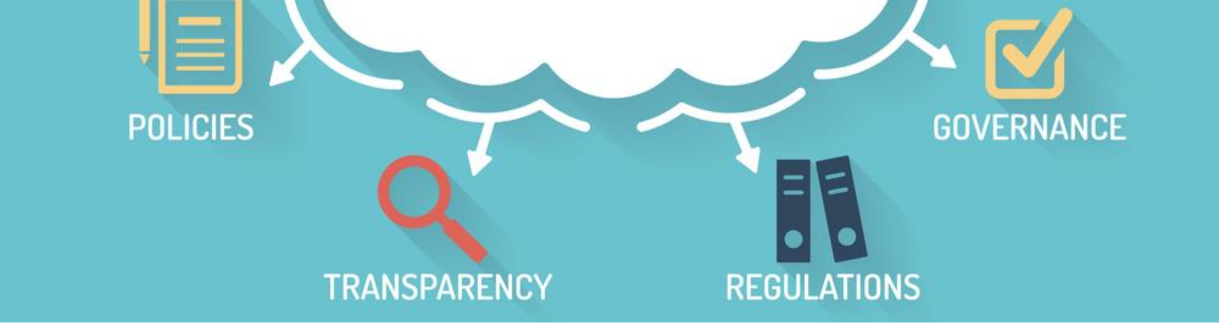
The creditworthiness of each Debtor is vital to a Factor and will help determine how much risk the Factor will be willing to undertake. This clause provides for the power of the Factor to approve each Debtor before agreeing to purchase the relevant receivables. A Factor may also request that a Seller should provide other documents such as its certificate of incorporation, the constitutional documents, corporate authorisation for the transaction, a list of customers/debtors, relevant tax returns, audited financial statements, etc., as conditions to the transaction.

Tax Considerations

As previously stated, debt factoring is still in its early stage in Nigeria. As a result, there is currently no specific tax regime for debt factoring. Consequently, the existing tax laws will govern debt factoring transactions. Under Nigerian law, Value Added Tax ("VAT") is payable on all goods and services except those specifically exempted under the VAT Act[6]. The VAT Act imposes VAT at the rate of 7.5% on services and defines services to include intangible / incorporeal property which is capable of transfer from one person to another (excluding money and security). Based on this wide definition of services, the transfer of receivables (which are intangible / incorporeal properties) will be liable to VAT at the rate of 7.5%. Thus, the Seller will be required to charge on its invoice, collect and remit VAT at the rate of 7.5% when the Factor purchases the receivables. Being a consumption tax, the Factor has the obligation to pay the VAT to the Seller.

Another tax to be considered is Capital gains tax ("CGT"). The Capital Gains Tax Act 2004 (as amended) imposes CGT at the rate of 10% on the gains realised from a disposal of chargeable assets which include debts and incorporeal property such as the right to receivables. If receivables are classified as debts or incorporeal property, any gains realised from its disposal would be liable to CGT. As a result, while the receivables being purchased by the Factor are a chargeable asset, CGT would only be payable on the chargeable gains, if any, which is realised upon the disposal. Given that debt factoring involves the purchase of receivables at a discount, that implies that the Seller will not make any gains on the sale. In that case, the Seller will not make any gains on which it will be required to pay CGT following the sale of its receivables to the Factor.

[6] Section 2 Value Added Tax Act Cap V1, LFN 2004 (as amended by the Finance Acts 2019, 2020 and 2021)



The documents for the factoring will be liable to stamp duty at the applicable rate of 1.5% of the consideration for the assignment. Failure to stamp the documents as required by the Stamp Duty Act[7] will, in addition to other penalties, make the documents inadmissible in evidence before any court or arbitrator in Nigeria.

Foreign Exchange Consideration

Foreign exchange consideration is only relevant where the Factor is an offshore entity, and the receivables are payable in Naira.

Dealings and transactions in foreign exchange in Nigeria are regulated by the Foreign Exchange (Monitoring and Miscellaneous Provisions) Act (Chapter F34), Laws of the Federal Republic of Nigeria 2004 and various other laws and regulations. Under the laws and regulations, a person is only permitted to access the Nigerian official foreign exchange market to purchase foreign currency to pay for what is described as 'eligible transactions.' Eligible transactions are defined as any transaction adequately supported by appropriate documentation and specified by the CBN from time to time. Based on the list of current eligible transactions as prescribed by the CBN, the transfer of Naira denominated receivables by Sellers in Nigeria is not classified as an eligible transaction. Consequently, Debtors resident in Nigeria will not be permitted to have access to the official market to purchase foreign currency to settle receivables to offshore Factors.

Risks and mitigating the risks

As we have indicated earlier, debt factoring is a useful tool to enable an entity to maintain a healthy cashflow for its operations. This benefit notwithstanding, as in any other structure, there are some risks that are inherent in debt factoring transactions. These risks include:

(a) **Strain on customer relationship:** Satisfied customers and customer feedbacks are essential drives for businesses to grow and thrive. This is why organisations cultivate a culture on ways to handle clients and their peculiarities. Debt factoring, however, introduces a third party into the Seller's relationship with the customer. That may be a significant issue where the customer does not like dealing with third parties for invoice settlement or if the Factor is unable to maintain the sort of cordial relationship that the customer enjoys with the Seller. This could be mitigated by the Seller continuing to relate with the customer to ensure that the customer continues to receive the same treatment notwithstanding the sale of the receivables.

(b) **Business Stigma:** Businesses thrive on reputation, and they do whatever is within their control to protect same. Debt factoring is sometimes associated with businesses that are struggling to manage their cash flow. This may be as a result of so many factors including a misconception in the market that the business is failing. To this end, such a negative misconception could have an impact on the willingness of prospective customers to approach a business or the ability to retain the existing customers. Businesses will need to take steps to allay such misconceptions and fears.

[7] Stamp Duties Act CAP. 441 LFN, 1990

(c) **Limited Security**: Debt factoring limits other sources of funding such as bank overdraft which may require book debt as collateral. A company will always need to weigh whether engaging Factors could affect its ability to access other sources of financing and to take steps to balance the competing interests.

(d) **Data Privacy**: The Nigeria Data Protection Regulation, 2019 and the Nigeria Data Protection Regulation, 2019: Implementation Framework, 2020 places an obligation on data controllers to disclose what personal data is being processed, the specific purpose of processing the personal data, and obtain the consent of the data subjects to process the personal data. Based on the regulations, Sellers have an obligation to disclose to the Debtors that any personal data collected during the course of the contract may be made accessible to Factors should the need arise for the purpose of debt factoring. The regulations also provide that where the personal data is to be used for a purpose other than that for which it was collected, the data subject must be informed of this purpose and must give additional consent for the use of the personal data for that purpose. This provision would be useful where debt factoring was not envisaged at the time the company entered into a contract with the Debtor. To avoid breaching the regulations, clauses on data protection will need to be included in transaction documents and Sellers will need to obtain Debtors' consent to the disclosure of their personal data.

Conclusion

Factoring is fast becoming recognised by companies in Nigeria to manage and control cash flow and improve credit management. To this end, it would be helpful to have a legal regime specific to factoring in place to set standards, protect and deepen the market, and promote professionalism and ethics in the recovery of debt through the Factors. We hope that the Bill is passed into law soon to give effect to these. Pending the passage of the Bill, parties engaged in factoring business will continue to rely on existing rules guiding contractual relationships to execute their transactions.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