Article Information

Author: Daniel Fitzpatrick
Service: Projects & Construction
Sector: Infrastructure

Factoring of Debtors and Leading with your Chin

Factoring agreements are very popular with subcontractors and suppliers in the construction industry, assisting cash-flow by providing a line of credit against accounts receivable. However, like any financial product, they can present complexities, pitfalls and at times surprises when pursuing debt recovery and enforcement action.

Factoring agreements are very popular with subcontractors and suppliers in the construction industry, assisting cash-flow by providing a line of credit against accounts receivable. However, like any financial product, they can present complexities, pitfalls and at times surprises when pursuing debt recovery and enforcement action.

Daniel Fitzpatrick, Special Counsel discusses.

Where a subcontractor is factoring its debts:

1. All of the subcontractor's invoices in respect of the work performed pursuant to the alleged contract note that the debt the subject of the invoice has been assigned to the factoring company (a standard requirement imposed under the factoring agreement).
2. However, the line of credit under the factoring agreement will usually not extend to invoices where the debt is disputed or where there is no written contract, the factoring agreement instead providing for a "pay when paid" arrangement in such circumstances.
3. Having not made any advance against such invoices, the factoring company is content to allow the subcontractor (at its own risk and cost) to pursue enforcement of the invoices in its own name.
4. The subcontractor therefore proceeds, in its own name, to take steps to recover the debt, utilising security of payment or by court proceedings.

Unfortunately for the subcontractor, the assignment of the debt under the factoring agreement can complicate debt recovery action.

Firstly, if the subcontractor chooses to sue for the debt under the contract by commencing court proceedings there is a real risk that its claim will be bogged down by arguments as to whether the assignment means that the right to sue has passed to the factoring company or instead remains with the subcontractor. The issue turns on whether assignment of debt under the factoring agreement has been perfected (by provision of appropriate notice of the assignment)[1] or instead is merely an assignment in equity. If it is found that the assignment has been perfected, then the subcontractor will not have standing to pursue the claim and its claim will probably fail.

In some circumstances it may be possible to substitute the factoring company as the plaintiff to the court proceedings, but that will have costs consequences. Pursuing an alternative claim in *quantum meruit* might also be considered, as claims in *quantum meruit* are not capable of assignment. But this is also not ideal as the entitlement to *quantum meruit* is harder to prove and to quantify than a simple debt recovery.

Secondly, factoring can cause problems when it comes to enforcement through use of security of payment legislation. While the recent Supreme Court decision in *Quickway Constructions Pty Ltd v Electrical Energy Pty Ltd*[2] has confirmed that the statutory rights under the *Building and Construction Industry Security of Payment Act 1999* (NSW)(**the Act**) were personal to the contractor as the person who did the work and not capable of assignment, that first instance decision is currently under appeal. If this decision is overturned, the result will be that construction businesses that factor their debts are barred from using the Act!

Another complication arising from factoring concerns the enforcement of debts through garnishee orders against a judgment debtor which is factoring. Garnishee orders are typically one of the most effective and commonly used enforcement tools available to judgment creditors (because they can be obtained quickly, for little cost and practically by stealth).

However, factoring can throw a spanner in the works. If the judgment debtor is 'factoring' all or most of its debts, then the pool of its potential debtors who can be garnished shrinks dramatically. This is because the debts are now owed to the judgment debtor's financier, (i.e. the factoring company) not the judgment debtor itself. This can have the effect of frustrating or neutralising your garnishee orders and many who operate on the fringes know and leverage off this. This was demonstrated in the Supreme Court decision in *West Tankers* ***[3]*** where a prior assignment of a principal's debt by a contractor to a financier under a factoring agreement was held to prevail against a claim in respect of the same debt made by a subcontractor utilising a withholding notice under the Act.

The key 'take-away' is don't lead with your chin, be informed about and mindful of the implications of both your own factoring and where-ever possible the factoring activities of those to whom you extend credit. Failure to do so may well result in your debt being knocked down for the count.

---

[1] Section 12 of the *Conveyancing Act* 1919

[2] [2017] NSWSC 1140

[3] *West Tankers Pty Ltd v Scottish Pacific Business Finance Limited* [2017] NSWSC 621