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# Fundamentals of — Factoring —

A guide to understanding factoring transactions, including advantages of factoring over traditional bank financing and key issues to consider in structuring and negotiating factoring agreements.

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**M**any businesses, both large and small, factor their accounts receivable (accounts). Factoring is sometimes wrongly perceived as a source of financing of last resort, favored by financially distressed companies that cannot obtain traditional bank financing. In fact, the majority of American factoring volume arises from contracts between large, old-line factors, many of which are bank owned or affiliated, and creditworthy client companies, many of which are in the apparel, textiles, furniture and footwear industries. Beyond these traditional factoring markets, factors today purchase accounts from clients in almost every industry, including electronics and other consumer goods, government contracts, medical services, construction, transportation and other service industries.

Prior to the financial crisis, annual American factoring volume rose to over \$136 billion. This fell back in 2009, but is now growing again. Despite the prevalence of factoring in the US, many attorneys, accountants, finance professionals and judges have surprisingly little knowledge of this old form of commercial finance. This article provides an overview of factoring, focusing on:

- How factoring works, including an explanation of non-recourse versus recourse factoring, and the services offered by factors.
- Advantages for businesses of factoring over traditional bank financing.
- The various types of factoring facilities.
- Notification versus non-notification factoring, and the factor's verification of accounts owed by the factoring client's account debtors.
- The legal and business issues typically covered by factoring agreements.
- Key issues to consider in structuring and negotiating factoring agreements.

>> This article is based on a Practice Note available on [practicallaw.com](http://practicallaw.com). For the complete, online version of this resource, which includes information on the factor's initial due diligence on prospective clients and the main documents and closing deliverables involved in factoring transactions, search [Fundamentals of Factoring](#) on our website.

## WHAT IS FACTORING?

Factoring is a three-party transaction. In consideration of a commission (also known as a discount fee), on an ongoing basis, the factor's client sells to the factor current (not overly aged) accounts owed to the client by third-party customers (account debtors), arising from goods sold or services rendered by the client to the account debtor. Depending on the form of factoring chosen, the factor may finance its client by making a cash advance to the client on the date of purchase of the subject accounts.

Accounts purchased by factors generally collect in about 45 days. Many factors limit accounts eligible for purchase to those aged 60 days or less. The factor or its client typically notifies the account debtors that their accounts have been purchased by, and are payable only to, the factor (see below *Notification and Verification*).

Traditionally, factors purchase accounts from their clients without recourse. This means that if a purchased account is not collected by the factor, due solely to the financial inability of the account debtor to pay, the factor must still pay its client the agreed purchase price. Because of, among other things, the factor's assumption of this credit risk, the purchased accounts are treated as having been sold to the factor in a "true sale." In other words, the accounts sold to the factor "go off" the client's balance sheet. However, even when the factor buys accounts without recourse, it still retains quality recourse and can charge back purchased accounts that:

- Are disputed by the account debtor.
- Breach representations and warranties made by the client to the factor at the time of sale (for examples of common representations and warranties, see below *Factoring Agreements*).

This said, in common American commercial parlance today, "factoring" includes any transaction structured in form as a purchase of commercial accounts receivable, even if no credit risk passes to the factor. In full recourse, non-traditional factoring transactions of this nature, purchased accounts that are not collected by the factor within a relatively short time, often 60 to 90 days, for any reason (including bankruptcy or some other financial inability of the account debtor to pay), are charged back to the client by its factor.

In most states, full recourse factoring transactions of this kind are re-characterized as secured loans, by the factor to its client, with the loan being represented by the factor's advance(s) on the subject accounts. However, in Texas and Louisiana, as a matter of state law, the intent of the parties to make a true

sale of accounts, even with full recourse, governs, and a full recourse factoring transaction is still treated as a true sale of accounts, if that is the stated intent.

Likewise, in many foreign countries, full recourse factoring is treated as a true sale of the subject accounts to the factor. In England, for example, full recourse factoring is treated as a true sale of accounts to the factor, if the parties intended a sale of the subject accounts. Consistent with this, the UNIDROIT (International Institute for the Unification of Private Law) Convention on International Factoring (1988), in Article 1(2)(b), defines a factor as a person who performs at least two of the following four functions:

- Finance for the supplier (factoring client), including loans and advance payments.
- Maintenance of accounts (ledgering) related to the factored receivables.
- Collection of the receivables.
- Protection of the factoring client against default by the account debtors.

In partial non-recourse factoring, a hybrid of traditional and more modern variations of factoring, the factor's assumed credit risk on the purchased accounts is limited by time. If the account debtor becomes insolvent or bankrupt before the expiration of the credit risk period (for example, 60 or 90 days from the invoice date), the factor bears the loss on the account, so long as the account is not disputed. If the account debtor becomes insolvent or bankrupt after the expiration of the credit risk period, the factor charges back the account to the client.

Factoring differs from traditional bank financing in that factoring involves a purchase and sale of the subject accounts, in a true sale thereof, by the client to the factor, rather than a lender's loan to its borrower, secured by borrower-owned accounts. Therefore, factors are primarily concerned with the quality of the assets being purchased (that is, the collectability of purchased accounts), instead of the client's ability to satisfy financial covenants and ratios. The factor focuses more on the creditworthiness of the client's customers, rather than that of the client itself.

## RELATED SERVICES PROVIDED BY FACTORS

Factors provide a number of services to their clients related to the factoring transaction. These include:

- **Credit protection.** In non-recourse (and partial non-recourse) factoring, factors provide credit protection to their clients. If a credit-approved account that a factor purchases without recourse is not disputed by the account debtor or otherwise ineligible, and is not collected due solely to the financial inability of the account debtor to pay, the factor must pay the full purchase price to its client.
- **Bookkeeping and collection services.** Factors often provide bookkeeping (ledgering) and collection services to

their clients for the purchased accounts. However, in certain non-notification factoring transactions, the factor hires its client to service the purchased accounts, as agent of (and under control of) the factor (see below *Notification and Verification*).

- **Financing.** Factors often provide financing to their clients by making an advance on the date of purchase. Typically, factors will advance an amount between 70% and 90% of the purchase price of the subject accounts. The advance can either be treated as an interest-bearing loan or as a partial prepayment of the purchase price. Most large factors treat advances as loans.

### ADDITIONAL SERVICES OFFERED BY FACTORS

Beyond factoring facilities, many factors also offer a range of other services to their clients, such as:

- Accounts receivable financing (revolving loans), inventory loans and other forms of asset-based lending, such as term loans.
- Purchase order financing.
- Letters of credit.
- Government contract financing.
- Import-export financing and other forms of trade finance.

>> For an overview of asset-based lending transactions, search [Asset-based Lending](#) on our website.

>> For information on letters of credit, search [Letters of Credit in Financing Transactions](#) on our website.

### ADVANTAGES OF FACTORING

Businesses can garner several benefits by factoring accounts, as compared to traditional bank financing. These include:

- Reduction of credit losses, in non-recourse and partial non-recourse factoring, by the factor's assumption of the credit risk on approved accounts.
- Reduction of credit and collection expense, and increased efficiencies in the billing and collection functions, by outsourcing some or all of these functions to the factor. This allows the client's management to focus their attention on production, marketing, purchasing and other functions, which can be especially attractive to small and mid-size businesses.
- Improved and more timely financial reporting, from the factor to the client, on matters such as:
  - the aging of open accounts;
  - account debtor payment (collection) history;
  - credit risk;
  - disputes with account debtors; and
  - deductions claimed by account debtors on their accounts, such as deductions taken for lost, returned or damaged goods or discounts claimed by the account debtor.
- Ability to obtain financing in the form of advances by the factor against purchased accounts, in advance factoring

facilities (see below *Advance Factoring*). Alternative forms of financing, such as asset-based lending, might not be available to a business, particularly if the factoring client:

- is newly formed;
  - is growing rapidly;
  - is thinly capitalized;
  - has a narrow customer base, so that a large volume of accounts are payable from only a small number of customers (excessive concentrations);
  - has slow-paying customers (bad turnover);
  - has high credit losses; or
  - is financially troubled.
- Few or no financial covenants, with higher or even unlimited funding on accounts accepted for purchase, especially in non-recourse factoring facilities.
  - Faster approvals.
  - More limited guarantees. For example, the factor may accept a validity and non-diversion guarantee from the client's principals that does not extend to credit risk assumed by the factor. By contrast, a lender might require a full guarantee.
  - Enhanced ability to raise sales and smooth out seasonal fluctuations in demand, for example, by obtaining seasonal over-advances from the factor. Here, the factor will make an advance to the client, in anticipation of later arising accounts receivable (not presently existing) to be generated by the client and sold to the factor at a later date.
  - A closer working relationship with the factor's employees than might exist with a bank loan officer administering a line of credit, together with access by the client to the factor's specialized industry knowledge.

### TYPES OF FACTORING FACILITIES

There are three principal types of factoring facilities:

- Maturity factoring.
- Collection factoring.
- Advance factoring.

#### MATURITY FACTORING

From the 1920s through the late 1970s, when most factoring clients were at the wholesale stage of the business cycle, meaning that their account debtors were manufacturers, distributors or other persons at the wholesale stage of the sales cycle (not retailers), factors often provided maturity factoring (also known as wholesale factoring) to these clients. In this form of factoring, pure credit protection is provided. The factor pays for credit-approved accounts on the average maturity date of the accounts purchased in the month, plus an agreed number of days for collection.

If a credit-approved purchased account does not timely collect, due solely to the financial inability of the account debtor to pay,

## FACTORING TERMINOLOGY

### Account Debtor

The customer of the client, who is the obligor on an account sold to the factor.

### Advance

In advance factoring, the portion of the purchase price of the factored accounts, often 70% to 90%, which is advanced by the factor to the client on the date of purchase. Some years ago, the factor's provision of an advance was referred to as "cashing the sale."

### Balance Payment

The balance of the purchase price payable to the client, on the terms of the factoring agreement, representing the balance of the purchase price for the subject account(s), beyond the amount of any advance thereon, net of fees and other charges owing to the factor.

### Batch

Also known as a schedule. A group of accounts purchased by the factor during a defined time period (for example, bi-weekly, weekly or monthly).

### Chargebacks

Disputed and ineligible accounts purchased by the factor but later returned (charged back) by the factor to the client under the terms of the factoring agreement, reversing the factor's purchase of those accounts, and other amounts charged back by the factor to the client, such as amounts relating to discounts, allowances and credits taken by the account debtor.

### Client

The seller of accounts, to the factor.

### Client Risk (variously, Department Risk or Mill Risk)

Those accounts purchased by the factor from the client on a full recourse basis, with no assumption of credit risk by the factor.

### Commissions (variously, Discount Fees)

The factor's charges to its client, as a percentage of the purchase price of the factored accounts, for assuming credit risk and for any billing, collection and other services the factor provides to the client.

### Dilution

The portion of purchased accounts that do not collect, expressed as a percentage of the face value of the purchased accounts.

### Disputed Account

An account that does not collect for reasons other than credit risk assumed by the factor (that is, for reasons other than the account debtor's financial inability to pay).

### Factor

The purchaser of accounts, from the client.

### Funding Limit

Also known as the facility limit. The amount beyond which no new accounts will be factored. Sometimes expressed as the maximum volume of purchased accounts not yet collected by the factor or, variously, as the maximum permitted balance of the factor's open advances.

the factor still pays the purchase price. No advances are provided. That is, there is no element of client financing in this form of factoring. However, clients benefit by obtaining a predictable income stream because the factor pays the purchase price on an agreed date (maturity), and assumes the related credit risk.

In the past 50 years, as the United States has changed from a manufacturing economy to a service economy, the number and level of maturity factoring facilities offered by factors to their commercial clients have likewise fallen. Before the mid-1970s, the wholesale division of American commercial factors was the larger and more profitable business unit as compared to the retail division, but today this is no longer the case. Some factors today no longer have separate wholesale divisions, as most account debtors of factoring clients today are retailers.

## COLLECTION FACTORING

Most factoring today is collection factoring (also known as retail factoring), where the account debtor is a retailer. The

factor pays its client for the purchase price of the subject accounts upon collection or, if a purchased account is not collected due solely to the financial inability of the account debtor to pay, the factor pays the client when the account is deemed collected. Depending on the terms of the factoring agreement, an undisputed account may be deemed collected if:

- The account remains unpaid after a specified date. Extended payment delays are deemed to be attributable to the account debtor's financial inability to pay.
- The client provides the factor with reasonable proof of the account debtor's financial inability to pay.

## ADVANCE FACTORING

Advance factoring can take the form of either maturity factoring or collection factoring, except that, in advance factoring, the factor provides financing to the client on the date of purchase by making cash advances. The advance rate is typically between 70% and 90% of the factor's purchase price.

### Funds-in-use

Also known as funds employed. The sum of the factor's open advances that are not yet collected, plus all other fees and expenses due from the client to the factor.

### Ledger Debt

The indebtedness of the factor's client to a third party, itself also a client of the factor, for goods sold or services rendered. Factoring agreements typically include ledger debt within the meaning of indebtedness owed to the factor, for purposes of set-off.

### Maturity

The date when purchased accounts are due and payable under the contract between the client and its account debtor. Varies, the date when the factor, in a maturity factoring agreement, pays its client, on the average monthly maturity of the purchased accounts.

### Non-purchased Accounts

Client-owned accounts that are not sold to the factor, but are often pledged by the client to the factor as collateral security for fees, expenses and other obligations owed by the client to the factor under the factoring agreement. Collections of these non-purchased accounts are sometimes referred to as non-factored funds.

### Old-line Factor

A factor that purchases client accounts without recourse, assuming the credit risk thereon, and that generally also:

- Notifies the account debtors of the assignment.
- Collects the purchased accounts (sometimes in the factor's own name).
- Maintains a detailed bookkeeping ledger for the purchased accounts.

### Reserve

An unsegregated amount on the factor's books, generally a credit balance (due to the client), representing the net of:

- Credits for:
  - the amount of the purchase price owed by the factor to the client on the purchased accounts; and
  - any other credits (for example, collections received by the factor on non-purchased accounts).
- Debits arising from, for example:
  - advances made to the client on the date of purchase;
  - reserve releases, from time to time, by the factor to the client;
  - commissions, interest and other fees and charges owed to the factor by the client; and
  - chargebacks, by the factor to the client.

Roughly speaking, as a percentage, on the date of purchase, the reserve equals the inverse of the advance rate (that is, if the advance is 80%, the reserve, before the various charges, is 20%).

For a more complete glossary of factoring terms, see *American Factoring Law, 2011 Supplement*.

In some advance factoring facilities, the factor's initial advance is not treated as a loan but, rather, as a prepayment against the factor's contractual purchase price. The entire purchase price may be discounted back with interest, at an agreed rate (known as discount factoring). Or, the initial advance may not be discounted, if the factor charges a relatively higher factoring commission.

### SPOT FACTORING AND BLOCK DISCOUNTING

Spot factoring involves a one-time purchase of a single invoice. In a variation known as block discounting, factors purchase many invoices in a single block. Spot factoring and block discounting are both outside the scope of traditional factoring, as factoring is an ongoing arrangement involving continued purchases of accounts. Spot factoring is generally costlier than traditional forms of factoring, reflecting the higher risk and greater expense associated with one-time purchases.

## NOTIFICATION AND VERIFICATION

In most factoring agreements, factors give notice to account debtors that their accounts have been sold to the factor. They also usually require that:

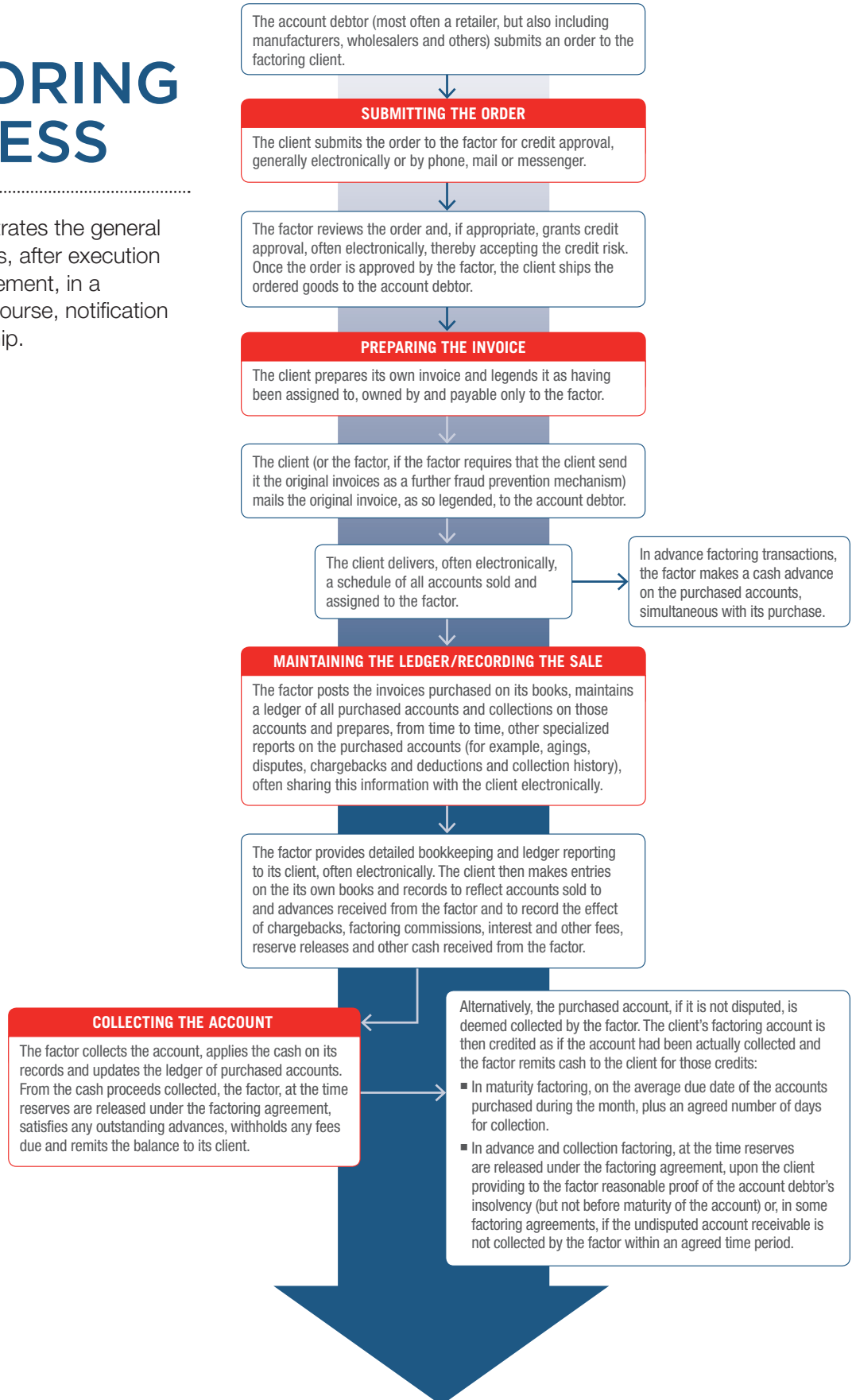
- Invoices be marked as sold to the factor.
- Account debtors make all payments on purchased accounts directly into a lockbox controlled by the factor.

Article 9 of the Uniform Commercial Code (UCC) addresses, among other things, issues related to notification and defenses of the account debtor. For example:

- Under Section 9-404(a)(1) of the UCC, the factor is subject to all terms of the contract between the account debtor and the factor's client and, therefore, to claims in recoupment or defenses arising under that contract.
- Under Section 9-404(a)(2) of the UCC, if a factor gives notice to an account debtor of its purchase of the

# THE FACTORING PROCESS

This flowchart illustrates the general sequence of events, after execution of a factoring agreement, in a traditional, non-recourse, notification factoring relationship.



account debtor's receivable, the account debtor cannot set off against the purchased account for any other defense or claim which arises after the account debtor receives this notice.

- Under Section 9-404(b) of the UCC, any account debtor claim against the factor's client serves only to reduce the account debtor's liability to the factor-assignee, and the factor is not subject to any affirmative liability in respect of the assigned accounts. (For a more detailed discussion of Section 9-404 of the UCC, see *American Factoring Law, Ch. 7.II.A.*)
- Under Section 9-406 of the UCC, once an account debtor is notified that its account has been sold by the client to a factor, the account debtor's obligation to the factor is not discharged if the account debtor instead pays the client. This reduces the risk of fraud that would occur if a client, in breach of its factoring agreement, continued to collect sold accounts and retained the collected proceeds, rather than paying them over to the factor.

About 20% of American factoring volume today is done on a non-notification basis. In some forms of non-notification factoring, the factor purchases accounts as they are created and the factoring agreement provides that the client serves as the factor's collection agent (subject to collection parameters set by the factor and to the factor's right, in its discretion, to terminate the client's role as servicer and to directly collect). The client then turns collected proceeds over to the factor, if they are not directed to a lockbox controlled by the factor, as the factoring agreement may require.

In other forms of non-notification factoring, the factor purchases accounts only once they age past an agreed date or go into payment default. Factors generally charge more for non-notification factoring because of the increased risk that the client may divert collection proceeds away from the factor.

Factors may also require accounts to be verified before they purchase them (although this is not typical for large, old-line factors dealing with established clients). Verification involves the account debtor confirming that:

- The amount payable is correctly shown on the client's invoice or purchase order.
- It does not assert any defense, offset or counterclaim against its obligation to pay.

Verification is conducted both in writing and by telephone. If an account debtor verifies an account to a factor, the factor has an independent cause of action (based on promissory estoppel) against the account debtor if it fails to pay.

## FACTORING AGREEMENTS

Factoring agreements are two-party agreements between the factor, as the purchaser of accounts, and its client, as the seller of accounts. They are variously called, for example, Factoring Agreement, Accounts Receivable Purchase Agreement, or

Sale and Servicing Agreement. Factoring agreements cover a wide variety of legal and business issues, including:

- The sale and purchase of the subject accounts, with the purchase price being, generally, the face value of the purchased account(s), less contractual discounts and other deductions allowed or allowable, whether or not taken by the account debtors, less the factor's commission (or discount fee).
- Whether accounts are purchased on a non-recourse, partial non-recourse, partial recourse/split risk (where credit risk on purchased accounts is shared between the client and the factor, on agreed terms) or full recourse basis.
- Whether accounts are purchased on a maturity, collection or an advance factoring basis.
- Whether accounts are purchased on a notification or non-notification basis (see above *Notification and Verification*).
- The term of the factoring agreement.
- The purchase price payable for factored accounts, the amount of the factor's commission and any other fees and charges payable by the client to the factor (see below *Factor's Fees and Expenses*).
- Whether any advances are treated as interest-bearing loans made by the factor or partial prepayments of the purchase price owed by the factor. Advances are commonly treated as loans by large, old-line factors and typically bear interest at a floating rate set out in the factoring agreement. In factoring agreements that treat advances as partial prepayments, the agreement specifies any applicable discount to the purchase price (see below *Character of the Factor's Initial Advance*).
- Reserves held by the factor, and the timing of reserve releases back to the client.
- Chargeback rights for disputed, partially paid and ineligible accounts.
- The client's grant of a security interest to the factor, as owner of the purchased accounts, and also, as lender, on non-purchased accounts and any other collateral taken by the factor, including credit balances owed to the client.
- Whether the client must offer all of its accounts to the factor for purchase (although this is not typical, at least for smaller factors), and whether the factor has discretion to reject accounts that are offered to it.
- Representations and warranties by the client about the nature and validity of both the purchased accounts and the non-purchased accounts being pledged as collateral, for example, that the accounts:
  - are validly owned by the client;
  - are not subject to liens, offsets, defenses or counterclaims;
  - are within applicable concentration limits;



## CHOOSING A FACTOR

Clients consider several criteria when choosing a factor. These include:

- Reputation.
- Pricing (such as level of factoring fees and size of advances).
- Products and services. For example, if credit protection is required, clients must consider whether the prospective factor offers non-recourse or partial non-recourse factoring facilities. Clients may also consider whether the factor will buy accounts on a non-notification basis, if the client so desires.

- Industry experience.
- The nature and level of collateral required, beyond accounts, if the factor is advancing funds.
- Online access to information about purchased accounts.
- Speed of response, reliability of the factor and the ability to reach key decision-makers quickly.
- Financial strength and stability of the factor.
- Personal service.

- were not previously rejected for purchase by the factor; and
- have not been re-aged.
- Representations and warranties by the client about itself, including, among other things:
  - its exact legal name and state of organization or formation;
  - that its execution and performance of the factoring agreement are duly authorized, do not breach other contracts and do not require third-party consents; and
  - that it is not insolvent or bankrupt.
- Covenants by the client, including, among other things, commitments:
  - not to change its state of organization or formation without giving the factor prior notice;
  - not to change lockbox instructions and procedures or sweep instructions without the factor's permission; and
  - to include a legend on the invoice for all accounts sold to the factor, providing notice of the sale of the account to the factor and instructions to pay the factor directly.
- Concentration limits for account debtors.
- The factor's set-off rights. The factor can set off indebtedness of the client to the factor, for advances received, interest, legal fees, ledger debt and other charges, against monies (the credit balance) that the factor owes the client, arising from sums owing for the purchase price of the factored accounts (that is, net of initial advances).
- The extent of guarantees (if any) by the client's owners or managers, or by other third parties, of the client's obligations to the factor. For example, a guarantee in favor of a factor could be a full guarantee of collection, meaning the guarantor assumes all risk that the purchased account will not collect, including credit risk. Alternatively, a more limited validity guarantee only protects the factor against a sale of ineligible accounts by the client to the factor and, in some cases, also against diversion by the client of the collected proceeds of factored accounts, if they are not turned over by the client to the factor as required.

- In limited circumstances, financial covenants relating to the client's financial condition.
- Billing and collection procedures, including who bills and collects the accounts and, where appropriate:
  - the treatment of non-factored funds; and
  - the client's agreement to act as contractual servicing agent for the factor, for accounts sold to the factor.
- Defaults.
- Boilerplate provisions governing matters such as authority, choice of law, waiver of jury trial and notices.

>> For a detailed list of the transaction documents and closing deliverables commonly used in factoring transactions, including an explanation of certain subordination and indemnity issues between existing and incoming factors, see the complete, online version of this resource. Search [Fundamentals of Factoring](#) on our website.

## STRUCTURING AND NEGOTIATING FACTORING AGREEMENTS

Before advising a client about a prospective factoring arrangement, counsel should consider the client's goals and consider the following key issues:

- The type of factoring that best suits the client's needs.
- Whether the transaction involves a true sale of accounts to the factor.
- Commissions, fees and expenses payable to the factor.
- The character of the factor's initial advance, if applicable.

## CHOOSING THE TYPE OF FACTORING FACILITY

The following matters are important to a client's decision about the type of factoring facility that best addresses its needs:

- If the client needs credit protection, non-recourse maturity factoring (if the account debtors are on the wholesale side, such as manufacturers or distributors) or non-recourse collection factoring (if the client, for example, sells to retailers) may be most appropriate, or a partial non-recourse facility, depending on the level of credit protection required. If the client does not require credit protection, but needs bookkeeping, ledgering and collection services, a recourse factoring facility may be more suitable.

- If the client requires financing from the factor, the client should request an advance factoring facility, which can be provided on either a maturity or a collection basis.
- If the client wishes to make a one-time sale of accounts to enhance its cash flow, spot factoring may be most appropriate.
- If the client does not require bookkeeping, ledgering and collection services from the factor, non-notification factoring may be most suitable because the account debtors are not told that their accounts have been sold to a factor.

### TRUE SALES AND OFF-BALANCE SHEET FINANCING

Under prevailing American law, client accounts that are sold to the factor without recourse are treated as having been sold to the factor in a true sale and the accounts sold go off the client's balance sheet. This can be useful, if the client is bound by covenants in other commercial agreements that prohibit the client from taking loans against accounts, but do not prohibit it from selling accounts.

Except in transactions governed by Louisiana and Texas law, under prevailing American law, full recourse factoring is generally not treated as a true sale of accounts to the factor, but is characterized instead as a secured loan (see above *What is Factoring?*). (For a detailed discussion of true sale issues and each party's accounting in a true sale of accounts, see *American Factoring Law, Chs. 4 and 14.*)

### FACTOR'S FEES AND EXPENSES

Clients must consider whether their gross margins will be sufficient to cover the cost of factoring. Factoring fees depend on several variables, including the:

- Anticipated factoring volume.
- Invoice size.
- Age of the purchased accounts (the older the accounts, the higher the risk and the pricing).
- Number and diversity of the account debtors.
- Credit profile of the account debtors.

The factor's fees and expenses include:

- **Commissions.** Factors charge commissions for the credit risk they assume and for providing bookkeeping, ledgering, collection and other administrative services to their clients. Clients should consider that:
  - large factors often charge low commissions on their purchases of accounts, with about 1% being common (and generally in the range of .5% to 2.5%), however, they also charge interest on advances they make to their clients, typically at rates based on the prevailing prime rate, plus an additional margin; and

- smaller factors generally charge higher commissions, but often do not charge interest on advances and, in some cases, the commission varies over time, subject to an overall cap (for example, the factor's commission could be 1.5% per month, subject to an overall cap of 15%).
- **Commitment fees.** Factors typically charge commitment fees at inception of the factoring facility.
- **Interest.** Factors charge interest on advances (often, on the average daily amount of monthly advances) if the advances are interest bearing and treated as a loan. Where advances are instead treated as a prepayment of the purchase price and, sometimes, discounted, the discount represents an amount equivalent to the interest that would have been earned on the advance, if it had been treated as a loan from the date it was made until the collection, or deemed collection, of the purchased accounts (see below *Character of the Factor's Initial Advance*).
- **Additional fees.** Additional fees may apply in any given factoring agreement. For example, some factors charge minimum monthly discount fees, and early termination fees may also apply if the client wants to terminate the arrangement ahead of its stated expiration date. Other fees may also apply.

### CHARACTER OF THE FACTOR'S INITIAL ADVANCE

As discussed above, most large, old-line factors today treat advances as interest bearing loans to the client. Some factors, however, treat the initial advance as a non-interest bearing prepayment of the factor's purchase price of the subject accounts, but charge a higher discount fee. Because the purchase price is not payable by the factor until the accounts mature, some factors discount the amount of the initial advance to reflect the client's early receipt of funds.

If the advance by the factor is treated as a:

- Loan, the outstanding amount of the loan is repaid by set off against the factor's obligation to pay the purchase price of the accounts. In this case, the factoring agreement addresses all lending aspects of the factoring arrangement and separate promissory notes are not executed.
- Partial prepayment, the amount of the advance is set off against the full purchase price, but receipt of the advance does not give rise to indebtedness owed to the factor. Rather, the advance just reduces the balance of the purchase price owed by the factor to the client.

>> For the complete, online version of this resource, search [Fundamentals of Factoring](#) on [practicalcallaw.com](#).