

Legal Updates

Vinod Kothari & Company

Law of Assignment of Receivables

Vinod Kothari
Vinod Kothari & Company

Legal Updates

Assignment of receivables out of transactions is growing astronomically; though without any numerical evidence, but one can say that the total volume of sale of loans and sale of receivables might be exceeding global trades in goods and services put together. Assignment or transfer of receivables is taking place for variety of purposes – securitisation, loan sales, originate-to-transfer transactions, security interest, transfer of servicing or collection function, sale of distressed loans to loan resolution companies, and so on.

While the global usage of assignment of receivables has become so common, the body of law that defines what can be assigned, what is the impact of restrictions on assignment, what happens upon assignment, etc., is still anchored in 19th Century principles, and in most countries, there may not be a specific law dealing with assignments. This is a pity, given such clear laws dealing with sale of goods.

Before getting into the subject, just a bit of clarity on the jargon. Assignment of debt, assignment receivables, assignment of actionable claims, assignment of choses in action, assignment of things in action, transfer of receivables, sale of receivables, loan sales, etc are all terms that point to the same thing. This article is relevant for each of these. Assignment may lead to securitisation –this article does not deal with the law of securitisation.

Commercial risks in originate-to-transfer model:

This article is on the legal issues of assignment; however, as most assignments take place in context of loan trading or receivables acquisition business, it is important to mention some significant commercial risks of the originate-to-transfer model.

The subprime crisis of 2007-8 brought to focus the risks of what came to be known as the originate-to-distribute model. The word “distribute” pertains to securitisation transactions – a more generic word is “transfer”. There are plenty of commercial transactions today which are originated and sold by the originators to others. Banks/brokers originate loans and sell them; vendors originate leases and sell them; within the world of financial institutions, trading in loans takes place very commonly. Hence, it may sound highly anachronistic to talk of the risks of originate-to-distribute model, but then, some significant risks are as follows:

Legal Updates

- The originator extracts the whole or substantially the whole of his equity in the transaction; therefore, originator does not have significant skin-in-the-game. In most cases, originators may also be putting the assets off the balance sheet – hence, originators may not have sufficient stakes, to be vigilant about the transaction.
- The originator's business model may be non-compliant with several applicable laws. Hence, the assignee's rights would be subjected to all such counterclaims that the originator would have faced.
- Since originator extracts equity upfront, originator may have business policies aimed at the short-term, compromising the long term.
- After all, the assignee acquires such rights as the originator has, in the originating agreement. Assignee would not have drafted/approved the origination agreement. Hence, if there are any deficiencies, gray areas or weaknesses in the origination agreement, the same will be inherited by the assignee as well.
- If the originator has made any promises, representations or other averments, at the time of doing the transaction, the assignee will be affected thereby. Sometimes, there may be correspondence, mail trails etc which may not have been disclosed to the assignee.

All this highlights the need for the assignee to be extra vigilant.

Meaning of assignment:

While the current level of commercial use of assignment has never been seen in the past, assignment of debt or contractual benefits has been there ever since law of contract has existed, and has almost been the same over the ages.

The word assignment is used in context of incorporeal, that is, intangible assets. Corporeal assets are transferred; incorporeal assets are assigned, as the physical dimension of transfer, meaning change of hands, is not applicable in case of intangible assets. As physical assets may be transferred either for sale, or security, or exchange, or gift, likewise, assignment of incorporeal assets may be done either for sale, or exchange, or gift, or pledge or creation of security interest. If it is a sale, gift or exchange, the assignment will be absolute; if it is merely by way of a security interest, it may be conditional or specific.

Assignment of contract or assignment of benefits under contract:

Users are quite often confused as to whether a contract is being assigned, or benefits under a contract are being assigned. A contract is a bunch of mutual rights and obligations. Assignment of a contract would mean assignee steps in the shoes of the assignor and assumes all the rights and obligations of the assignor. For example:

- X enters into a contract of sale with Y where X is the seller. The contract would obviously provide for rights and obligations of either party. X will have the obligation to deliver what he promised to sell, and to ensure that the subject matter adheres to such specifications, conditions and fitness as is either explicitly agreed upon or implied. X has the right to receive the price. Y has the obligation to pay the price, and the right to receive goods.
 - Assignment of the benefits under the contract by X would mean the receivables under the contract, that is, the price for the goods, may be assigned to P.
 - Assignment of the contract by X would mean P becomes the counterparty to the contract of sale, which is now a contract between P and Y.
- This is true for most contracts, as any contract would imply a bunch of mutual rights and obligations.

The general position in law is that a contract is assignable only with the consent of the counterparty. This is most logical, because holding otherwise would expose the counterparty to obligations of a party with whom it never dealt. Holding otherwise would land up Y in contract with P, who Y had never selected.

On the contrary, assignment of the benefit of contract, that is, rights arising out of contract, does not at all impact the counterparty, as the counterparty can still enforce his rights, that is, the assignor's obligations, against the assignor. All assignor transfers is his rights. In the example above, if X transfers the receivable to P, there is no adverse implication for Y.

General rule on assignment of benefits under contract:

Hence, the general rule on assignment is:

- Assignment of a contract is permissible only with the consent of the counterparty;
- Assignment of rights of benefits under a contract is permissible without the consent of the counterparty.

Legal Updates

If the assignment of the contract is done with the consent of the counterparty, that amounts to a novation – that is, partial re-writing of the terms of the original contract.

Exceptions to the assignability of benefits under a contract:

The rule above, that the benefits under a contract are assignable, is subject to some important exceptions:

- Contracts involving the credit, skill or personality of the assignor cannot be assigned. For example, a bank agrees to give a loan to X. X cannot assign the right to receive the loan to P, as the loan was based on the credit of X. Likewise, if a tailor agrees to stitch a suit for X, X cannot assign the right to have a suit stitched to Y.
- Contracts of personal service cannot be assigned. For example, if Y agrees to serve the office of X, X cannot assign the service contract to P.
- If the contract expressly prohibits the right of a party to assign his receivables or benefit under a contract, then such receivables/benefit are not assignable, or not assignable without the consent of the counterparty. There have been several rulings on the impact of prohibition under contract on assignability of benefits under, particularly, something a like a debt. More than a century ago, in *Re Turcan* (1888) 40 Ch.D.5, it was held that if a life insurance policy was not assignable, it did not prevent the insured from declaring himself as a trustee for the assignee. In *Barbados Trust Company Ltd Bank of Zambia and Anr* [2007] EWCA Civ 148 the House of Lords held that a prohibition on assignment operates only between the assignor and the counterparty to the contract, and not between the assignor and assignee – hence, the contract to assign would still operate as equitable assignment.

Assignment of future benefits under contract v. assignment of benefits under future contracts:

A contract may give rise to benefits in future – for example, a contract of sale on credit creates a right to receive the sale price at the appointed time. This is an existing debt, though payable in future. There is no doubt as to the assignability of such debt.

A contract may also create future receivables, which either do not exist now, or are contingent, conditional or uncertain right now. For example, if a landlord has let out property to a tenant, the tenant will have rentals to pay in future, but as these rentals are based on continuing performance, they have not become unconditional or non-contingent right now. The rule on assignability of future debt is that future debt is also assignable, though such an assignment would operate when the receivable comes into existence.

Legal Updates

There is elaborate discussion on assignment of future debt in Vinod Kothari: *Securitization: Financial Instrument of the Future*.

However, as regards assignability of contracts in future, that is, contracts not yet entered into, it is highly speculative and contingent, and other than as a promise on the part of the assignor to assign benefits of such contracts as may be entered into in future, such an assignment has no relevance.

Rights of the assignee:

Rights of assignee are no better than those of the assignor, as the assignee steps into the shoes of the assignor. A very old text [Alfred W. Bays *American Commercial Law Series*, 1920, sec 122] puts it as follows: “The theory of contract being that it is a personal relationship between two or more persons who have chosen each other, assignment of rights thereunder, without the other party's consent, is permitted, as we have seen, upon the theory that the contractual arrangement is not thereby disturbed. It follows from this, that such assignment cannot be permitted to increase the obligations of the other party thereunder. Therefore, the assignee will take the right as it actually exists, not as it may seem to be; and will take it subject to all adjustments and defenses to which the assignor would have been subject had there been no assignment”. That is to say, the counterparty to the contract cannot be put to a disadvantage by virtue of an assignment, as assignment is merely a transfer of rights that the assignor had.

Assignment of receivables versus sale of the asset:

Practitioners are sometimes not clear about assignment of receivables, versus sale of the asset from which receivables arise. Take, for instance, the case of a lease of an asset. Assignment of receivables would mean sale of the lease rentals, not the asset. In that case, the leased asset still remains the property of the assignor – that is, the assignor has retained the residual interest in the asset. However, it would be different if the lessor sells the asset that has been leased out.

Assuming that it is contractually possible to sell the leased asset, if X sells the asset to P, there is no need to separately assign the receivables arising out of the lease. The lease rentals flow from the asset – if the asset has been transferred, the receivables automatically flow from the asset.

Legal Updates

Issues pertaining to assignment:

There are host of legal/taxation/accounting issues that pertain to assignment of receivables, and the complete matrix may be indeed very complex. Following is only a brief pointer to the legal issues that may arise:

Legal formalities on assignment:

Legal systems of most countries would lay down what is required to give effect to assignment. For example, sec 136 of the UK Law of Property Act deals with the procedural formalities to give effect to a transfer of a “thing in action”, that is, actionable claims. Section 130 of the Transfer of Property Act in India deals with assignment of actionable claims. These legal provisions essentially provide that an assignment must be by way of an agreement in writing, and such assignment must be notified to the debtor. Why is notice to the debtor required? The answer is obvious – how is the debtor expected to recognise the rights of the assignee, who he never dealt with, and has not been notified of. The interpretation of this requirement is that if the assignment is silently done between the assignor and assignee, and has not been notified to the debtor, it would nevertheless be good as between the assignor and assignee, but would not be operative against either the debtor or the world at large. Such an assignment is called *equitable assignment*.

Stamp duty on assignment:

As law stipulates a written instrument for assignment of actionable claims, an assignment is achieved by an instrument – this instrument mostly requires stamp duty. Since laws drawn years ago may not have realized the frequency of assignments taking place in the current financial world, sometimes, the rates of duty on assignments are ridiculously high.

Off balance sheet treatment following assignment:

One of the most tricky questions for parties to ask is – does the assignment lead to an off-the-balance sheet treatment for the assignor? The answer may not be short, but some quick rules are as follows:

- First, was the assigned asset on the balance sheet of the assignor? If something was not on the balance sheet to begin with, the question of the asset going off the balance sheet does not arise at all.
- Is the assigned asset a financial asset? The word financial asset is defined in accounting standards (e.g., IAS 32). Accounting standards on derecognition of financial instruments will be applicable if the asset was a financial asset – IAS 39,

Legal Updates

for example. On the other hand, if the assigned asset is an intangible property, relevant accounting standards are applicable. If the assigned asset is a tangible property, it may well be a wrong use of the term assignment, as in that case, it would be a sale of tangible property, and relevant accounting standards such as on property, plant and equipment may be applicable.

- If the assigned asset is a financial asset, there are several conditions for off-balance sheet treatment put up by accounting standards. These have been discussed in Vinod Kothari's article on IAS 39 – see www.vinodkothari.com/tutorials/resources.html