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Validity of Forfaiting in International Trade Law and Islamic law

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***Abstract*:** *In international trade law, forfaiting is a method of financing that exporter sells the document evidencing a payment claim to a financial institution (bank) named as forfaiter on a without recourse basis. Therefore forfaiting has three aspects: financing method, documentary transaction and obligatory contractual relations. One of legal issues of forfaiting is its legal nature and validity. The importance of this topic is that The URF800 do not deal with the validity of forfaiting agreements and transactions and this important legal issue must resolved according of applicable law.*

The ICC uniform rules describe the forfaiting as sale of payment claim. In international trade law many legal system have recognized the validity of sale of commercial payment claims in form of forfaiting contract. In Islamic countries that their legal system are founded on Islamic law or Sharia, the forfaiting is considered as bey-o-deyn (sale of debt) and may be challenged in viewpoint of Islamic jurisprudence. In viewpoint of majority of Sunni jurists and minority of Shia jurists, the sale of debt by creditor to a third party is void. . Their reasons generally touches on the risks to the buyer, gharar (risk of uncertainty), caused by absence of delivery (qabadh) and doubtful Reba (usury). But most of the Shia jurists reject that reasons and subject to requirements, consider sale of debt legally valid and enforceable. Therefore, forfaiting transactions in primary market and secondary market in Iranian law that based on Shia jurisprudence may be valid.

Keywords: forfaiting, forfaiter, *Exporter, Payment Claim, legal nature, validity.*

1. Introduction

Forfaiting is a method of finance that to according arrangements between exporter (as seller) and a bank or specialized finance firm (as forfaiter), exporter sells, at a discount & on a without- recourse basis, the receivables that are due to mature at a future date. These arrangements involve some agreements and transactions which make forfaiting. Forfaiting is a mechanism of finance for exporters that enable them to increase their sales by transferring non-payment risks to professional financial firms.

However, unlike factors, forfaiters typically work with exporters who sell capital goods and commodities, or engage in large projects and therefore need to offer extended credit periods from 180 days to seven years or more. The current minimum transaction size for forfaiting is $100,000. In the United States, most users of for-faiting are large established corporations, but small and medium-size companies are slowly embracing forfaiting as they become more aggressive in seeking financing solutions for exports to countries considered high risk. [1, p 23]

Therefore financing, complex and multiple contractual relationships, assignment of documents that evidencing the payment claim, such as bills of exchange, promissory notes, documentary credits and invoice purchases, are three legal aspects of Forfaiting. In this article we study contractual aspect of forfaiting and its validity in international trade law and Islamic law according to Iranian law.

It must be noted that yet national legal systems didn't enacted especial provisions for forfaiting. Withstanding, International Chamber of Commerce (ICC) in cooperation with the International Forfaiting Association (IFA) have codified uniform rules for forfaiting in collection named as URF 800(2012), the first

standard set of rules for forfaiting transactions. URF has produced a single set of standardized terms and conditions for the two components of the forfaiting market- the primary in which forfaiting transactions are originated from exporters and secondary market where those transactions are traded between banks and other financial institutions. The forfaiting agreement is subject to the Uniform Rules for Forfaiting if the parties refer to it in their agreement. However, The URF do not deal with the validity of forfaiting agreements and transactions, hence, the parties will need to determine the governing law and jurisdiction and will also need to select the method of transfer, e.g. endorsement, assignment or novation, suitable for the instrument evidencing the payment claim, to ensure the transfer is effective. [2, p8]

2. Process of Conclusion of Forfaiting and Validity of Framework Agreement

According to article 2 of URF, forfaiting agreement is a written agreement signed by the primary forfeiter and the initial seller setting out the terms of the forfaiting transaction. And forfaiting transaction is the sale by the seller and the purchase by the buyer of the payment claim on a without recourse basis on terms of these rules. In this regard, there is two presumptions. First, the forfaiting agreement is independent contract include mutual obligations of parties to sell and purchase payment claim and forfaiting transaction is a sale contract. Second, these are same contract. The forfaiting agreement is conclusion of sale contract and forfaiting transaction is performance of it. Our presumption is later.

However, the parties before the main agreement may enter into a primary or framework agreement in the primary market where it is desired to establish the terms and conditions on which sales and purchases can be concluded in the future if and when a specific transaction has been identified.

The framework agreement is not binding per se and the seller is under no obligation to offer any payment claims for sale to the buyer and the buyer is under no obligation to purchase any payment claims offered to him by the seller. However, this does not prevent that in accordance with the terms of the agreement the forfeiter obliged to purchase and exporter has option to sell payment claims to it. Usually forfeiter don't demand any expenses for option less than 48 hours but for option more than 48 hours, the exporter must pay a sum as option price. [3, p98] In this case, the agreement is an option contract and a unilateral contract that its validity is accepted in contract law. [4, p54] an option contract is a contract to keep an offer open for a specified period of time so that the person making the offer cannot suddenly withdraw it during that period. [5, p192]. Indeed, the forfaiter offer his proposal and terms for purchase of payment claim and determine the discount rate and oblige itself to keep his offer and in contrast the exporter has option to sell his payment claim or no.

In Iranian law this agreement may be valid and enforceable according to article 10 of Iranian civil code but in viewpoint of some scholars in Islamic law, such agreement is not legally enforceable contract and it is considered as Vaad (promise) that is morally enforceable. [6, p55]. However, in the Islamic law, there is disagreement between scholars about enforceability of commitment to sale of things. In the viewpoints of some of scholars the independent commitments are valid and enforceable too. [7, p117]

3. Legal Nature and Validity of Forfaiting According to International Trade Law

As mentioned above, URF800 described the forfaiting as sale of *payment claim.* according to article 2 of this rule, *payment claim* means: **a**. *the obligation of the primary obligor to make payment of a specified amount on a specified date or on demand*; and **b**. *all the rights, title and interest to receive or recover payment from the primary obligor.*

In dictionaries of law, forfaiting is defined as a financial transaction involving the purchase of receivables from exporters by a forfaiter. The forfaiter takes on all the risks associated with the receivables but earns a margin. U.S. Department of Commerce in its *Trade Finance Guide* described forfaiting as *a method of trade finance that allows exporters to obtain cash by selling their medium and long-term foreign accounts receivable at a discount on a "without recourse" basis.* The United Nations Convention on the Assignment of Receivables in International Trade, defines "receivable" as a "contractual right to payment of a monetary sum".

The definition includes parts of and undivided interests in receivables. Receivables from any type of contract are included. While the exact meaning of the term "contractual right" is left to national law, claims from contracts for the supply of goods, construction and services are clearly covered, whether the contracts are commercial or consumer contracts. According to Romano-concept of obligation, contractual obligation is duty and debt of obligee and right and claim for obligor. Therefore, in civil law, as well as common law, main obligation of buyer in contract of sale is payment of price that in other side is the payment claim for seller. [7, p 1235]

In other hand, in two legal system, transfer of receivables or payment claim may be in format of assignment or sale contract. Although, in trade finance especially in Uniform Rules for Forfaiting, the form of sale is preferred. Section 2 of UK Sale of Goods Act (1979), define the contract of sale as a contract by which the seller transfer or agree to transfer the property in goods to the buyer for a money consideration, called the price. [9, p 1098] According to article 2-106 of UCC, "**sale**" consists in the passing of title from the seller to the buyer for a price. However, according to article 2-106, "**Goods**" means all things which are movable at the time of identification to the contract for sale other than the money in which the price is to be paid, investment securities (Article 8) and things in action. This rules is found in section 61 of SGA that state: Goods includes all personal chattels other than things in action and money. Things in action in general concept include debt and claim.

Hence, may be told in these systems the contract of sale is not the proper form for transfer of payment claim. However, considering to principle of freedom of contract it dose not seem that the sale of payment claim in English law and American law is considered invalid. Therefore, in article IV.A.-1:101 of DCFR, expressed that rules and principles of sales applies with appropriate adaptations to contracts for the sale of other forms of incorporeal property, including rights to the performance of obligations and debt claims.[8, p 1209]

4. Legal Nature and Validity of Forfaiting According to Iranian Law and Islamic Law

According to articles 338 & 362 of Iranian civil code, in contract of sale, the buyer obliged to pay determined price and where the monetary price has not paid the buyer owed a sum as price to the seller that scribed *deyn* (or debt) in Iranian law and other Islamic legal systems. Thereafter, the seller become creditor and the buyer become debtor. Analytically, the forfaiting is considered as *bey-o-deyn* (sale of debt) and may be challenged in viewpoint of Islamic jurisprudence.

In general, the majority of Islamic jurists include Sunni and Shia jurists, are unanimous in allowing the activity of selling debt by creditor to the debtor subject to some requirements. [10, p433]. They only differ in opinion about selling the debt by creditor to a third party for the reason that the seller will not be able to deliver the sold item to the buyer. The "sale of debt" has always been a point of contention among past and present Islamic jurists. However, there is no consensus among those who forbid it. The reasons generally touches on the risks to the buyer, *gharar*, caused by absence of delivery (*qabadh*) and doubtful *Reba* (*usury*). [11, p 17]

Whereas, most of Sunni jurist consider that transactions legally void; many of the Shia jurists reject that reason and subject to requirements, consider sale of debt legally valid and enforceable. [12, p 345]. Unlike view of minority of Shia jurist and majority of Sunni jurist, the doctrine of majority of Shia jurist is that the sale of debt by creditor to person other than debtor, subject to some requirements may be valid and enforceable, because the debt has economic value and the debt owed by debtor is considered as property for creditor and any proprietor can sell and transfer his property. [13, p20] This doctrine reject this reason that the receivable or debt is undeliverable and cannot be sold, because the delivery of each sold thing is deferent and seller by transfer of his payment claim to buyer of debt dominates him/her to enforce payment claim against debtor. Moreover, the delivery of documents that evidencing the payment claim is considered as delivery of their subject by common usage.

The probability of Reba in sale of debt at discount may be rejected since the word "*Reba*" literally means “excess" or "addition” and according to Islamic jurisprudence terminology, riba is any excess or surplus in addition to principal without due consideration whereas in forfaiting transaction there is not surplus or excess.

In Islamic law there are two kind of Reba. First, Reba–ye-gharzi, in loan contract with this term that borrower pay an amount or give a property in excess of principal. Second, Reba–ye-muameli, in sales, barters and exchanges that its subject matter is goods by weight or measurable goods when the same goods are exchanged. In second case Reba can arise when there is an exchange of two similar items or assets such as rice for rice. Then, in Sharia or Islamic law, Reba is confined to these categories of transactions. [14, p493] However, forfaiting agreement and transaction isn’t loan but it is an exchange in form of sale of debt and its subject is monetary debt or obligation and not weight or measurable goods. But according to doctrine that the Reba may occur in any exchange that deal items are same as money against money and one party get a sum in excess of that paid. Therefore, forfaiting may lead up to Reba.

However, forfaiting transactions in primary market and secondary market in Iranian law may be valid. Although, the parties must comply with sharia requirements and most important requirement is that the price must be in cash. Because, in viewpoint of Shia jurists sale of debt for debt is void. [15, p323] Then, as a matter of principle, forfaiting transactions in capital market, especially in secondary market, must not as such lead to sale of debt for debt.

5. Conclusion

Forfaiting is a method of financing that exporter sells the document evidencing a payment claim to a financial institution (bank) named as forfeiter on a without recourse basis. Therefore forfaiting has three aspects: financing method, documentary transaction and obligatory contractual relations.

The ICC Uniform Rules for Forfaiting (URF 800) describe the forfaiting agreement as a written agreement signed by the primary forfeiter and the initial seller setting out the terms of the forfaiting transaction and describe the forfaiting transaction as sale by the seller and purchase by the buyer of the payment claim on a without recourse basis on the terms of these rules.

One of legal issues of forfaiting is its legal nature and validity. The importance of this topic is that The URF do not deal with the validity of forfaiting agreements and transactions and this important legal issue must resolved according of applicable law. Although the ICC uniform rules describe the forfaiting as sale contract, some of authors suggest that the transfer of payment claim may be occur in form of endorsement, assignment or novation. In our opinion, the best and most proper description about legal nature of forfaiting is that the forfaiting agreement is conclusion of sale contract and forfaiting transaction is performance of it.

In international trade law many legal system have recognized the validity of sale of commercial payment claims in form of forfaiting contract. In Islamic countries that their legal system are founded on Islamic law or Sharia, analytically, the forfaiting is considered as *bey-o-deyn* (sale of debt) and may be challenged in viewpoint of Islamic jurisprudence. In viewpoint of majority of Sunni jurists and minority of Shia jurists, sale of debt by creditor to a third party is void. Their reasons generally touches on the risks to the buyer, *gharar*, caused by absence of delivery (*qabadh*) and doubtful *Reba (usury)*. But most of the Shia jurists reject that reasons and subject to requirements, consider sale of debt legally valid and enforceable. Therefore, forfaiting transactions in primary market and secondary market in Iranian law that based on Shia jurisprudence may be valid.

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