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Reducing The Regulatory Risk Of Merchant Cash Advances And Factoring

By **Clinton Rockwell, Moorari Shah and Lauren Frank** (May 17, 2019)

A growing number of courts and regulators have reached different conclusions on whether factoring and merchant cash advances constitute loans subject to state lender licensing and usury regulations, leaving many factoring companies and their clients without legal certainty about the nature of the transactions between them.

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Companies engaged in factoring (purchasing unpaid invoices) or merchant cash advance transactions (purchasing a percentage of future invoices and credit card sales) generally take the position that purchasing existing or future receivables is fundamentally different than lending.

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New York is one of a number of states that have taken that position, with courts deferring to the stated intentions of the parties involved in a given transaction in determining whether it constitutes a loan. However, in other states, most prominently California, courts have often characterized factoring and MCA transactions as disguised loans.

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The issue has recently become a hot topic among regulators. In February, the California Department of Business Oversight entered into a consent order alleging that certain factoring transactions constituted loans originated in violation of California’s constitutional usury limitations and the licensing requirements of the California Financing Law.[1] In addition, the Federal Trade Commission and New York attorney general have recently launched initiatives addressing potentially unfair or deceptive practices arising from MCA transactions.[2]

Though their interpretations vary, in all 50 states the determination of whether a factoring or MCA transaction constitutes a loan is a particularized inquiry in which the courts and regulators consider all of the circumstances surrounding a transaction. As a result, while it is impossible to remove regulatory risk altogether, these transactions can be structured to reduce the likelihood of recharacterization as a loan.

Listed below are the regulatory challenges that ineluctably follow when factoring and MCA transactions are recharacterized as loans. Also included are key considerations courts take into account when determining whether these transactions constitute a loan, and provide strategies to reduce the risk of that happening.

Implications of Recharacterization as a Loan

Two dominant state regulatory schemes affect the making of loans: usury laws andlending license laws.

State lending and usury laws are generally inapplicable to purchases of receivables. Therefore, whether a factoring or MCA transaction is considered to be disguised lending or a bona fide purchase of future or existing receivables has a material effect on the laws applicable to the transaction.

While licensing and usury laws vary by state, the majority of those that consider a factoring or MCA transaction a loan impose some form of licensing on the party initiating such transactions, and apply usury limitations to them.

Violation of state licensing and usury limitations may lead to a variety of remedies and penalties, including voidance of the transaction (potentially including principal), the inability to collect payments and the imposition of fines. A recent DBO consent order involving alleged disguised lending imposed a requirement that the company at issue refund the amount of fees, expenses and costs charged in excess of the 10% annual interest permitted under the California Constitution for all factoring transactions with California-based clients in the three-and-a-half year period preceding the consent order, and pay an administrative fee of $25,000 to the DBO.[3]

While violations of licensing and usury regulations are the most common risks, if a court or regulator determines that a factoring or MCA transaction constitutes a loan, the transaction itself may carry additional litigation and regulatory enforcement risks. For instance, where factoring or MCA transactions are recharacterized as loans, regulators may take the position that such transactions are subject to state or federal loan disclosure and advertising requirements, subjecting persons involved to potential liability for violations of the federal Truth in Lending Act, federal prohibitions on unfair, deceptive or abusive acts or practices, and applicable state analogs.[4]

Note that these risks are not strictly limited to factoring and MCA transactions. Pension advances, settlement advances and litigation funding advances, among others, bear similar transactional elements and risks and have seen increased regulatory and judicial scrutiny in recent years.[5]

In addition, factoring or MCA transactions that are not recharacterized as loans may nonetheless be subject to various regulatory pitfalls: For example, the transactions may be vulnerable to recharacterization as securities to the extent investors participate in MCA and factoring syndications with the goal of sharing in the profits.[6]

In addition, common contractual provisions in factoring and MCA transactions such as mandatory arbitration clauses and confessions of judgment have drawn fire in recent years as particularly onerous to small businesses that may rely on factoring and MCAs to pull through rough patches in their fledgling businesses where cash flow is particularly tight.[7]

Top 10 Factors Courts Consider

While courts in various jurisdictions consider a wide variety of factors in determining whether a factoring or MCA transaction is a bona fide purchase of existing or future receivables or a disguised loan, the following are the 10 factors most commonly considered, across jurisdictions (note these are factors, not a litmus test):

- Which party to the transaction bears the risk of loss;[8]

- Whether the factoring or MCA agreement, on its face, expresses an intent to enter into a loan;[9]

- The presence or absence of a maturity date or repayment schedule;[10]
- Whether the performance of the purchased account debtor is subject to a guaranty;[11]
- Any reconciliation between the merchant's sales and the amount paid to the factor (i.e., whether the repayment amount is fixed or variable);[12]
- Whether the agreement specifically charges interest or provides a method for computing interest;[13]
- With respect to factoring, whether there is any notification of assignment and redirection of payment to the purchased account debtor;[14]
- Whether the agreement is entered into in "good faith" and without the intent to evade state usury laws;[15]
- With respect to factoring, whether the title to the underlying account passed to the factor;[16] and
- With respect to MCAs, whether the merchant defaults upon any adverse material change in its financial condition.[17]

Mitigation Strategies

Those engaging in factoring and MCA transactions can take steps to structure such transactions in a way that mitigates the risk of recharacterization as a loan, including omitting:

- Personal payment guaranties in factoring or MCA agreements. By contrast, the inclusion of terms that increase the credit risk to be borne by the purchaser (or, stated differently, decrease the purchaser's recourse against the seller associated with incidents of nonrepayment) are likely to reduce the risk of recharacterization as a loan.

- Substantive provisions generally associated with a loan arrangement, such as:

- A fixed repayment schedule or maturity date;[18]

- Interest provisions, or fees that effectively are the equivalent of interest;

- Reserve accounts that permit the purchaser to withdraw funds for any shortfalls; and

- Any terms making a merchant's creditworthiness or financial status a condition of performance.

- Any right of the purchaser to collect personally from a merchant selling receivables in the event the merchant suffers a loss due to adverse business conditions, natural disasters or other factors beyond its control, or enters bankruptcy or closes the business; and

- The use of lending terms such as "borrow," "draw," "disbursement," and "finance charge."

Conclusion

In many jurisdictions, a genuine risk of nonrepayment is critically important to avoiding recharacterization as a loan. Therefore, persons engaging in factoring and MCA transactions must balance the need to protect themselves financially with the competing need to avoid structuring transactions so as to unintentionally subject themselves to state loan licensing and usury regulations.

On the whole, state legislatures have shown little interest in clarifying the basic nature of these transactions. Until they do, it will be up to those engaging in them to stay abreast of developing case law and to structure them with care so as to avoid undue financial and regulatory risk.

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[1] In the Matter of the Commissioner of Business Oversight v. BAM Capital, LLC, CFL File No. 60DBO-67944 (Feb. 12, 2019) (Consent Order).

[2] See "FTC to Host Forum on Small Business Financing," Federal Trade Commission (Feb. 14, 2019); "New York State Is Probing Abuses in Small-Business Lending," Bloomberg (Dec. 3, 2018).

[3] See supra at n.1.

[4] See e.g., Richard B. Clark v. Advanceme, Inc., No. 2:2008-cv-03540 (C.D. Cal. 2011); Consumer Financial Protection Bureau v. Future Income Payments, No. 8:18-cv-01654 (C.D. Cal. Sept. 2018).

[5] See e.g., Consumer Financial Protection Bureau v. Future Income Payments, No. 8:18-cv-01654 (C.D. Cal. Sept. 2018); Consumer Financial Protection Bureau v. RD Legal Funding, 332 F. Supp. 3d 729 (S.D.N.Y. 2018); Oasis Legal Finance Group, LLC v. Coffman, 361 P.3d 400, 407 (Colo. 2015).

[6] The U.S. Supreme Court has identified the following four elements as pertinent to the determination of whether a security exists: (1) an investment, (2) in a common enterprise, (3) with a reasonable expectation of profits, (4) to be derived from the entrepreneurial or managerial efforts of others. See S.E.C. v. W.J. Howey Co., 328 U.S. 293, 66 S. Ct. 1100, 90 L. Ed. 1244 (1946).

[7] See, e.g., "Fintech Investigative Report," Office of Congressman Emanuel Cleaver (Aug. 2018), available at https://cleaver.house.gov/sites/cleaver.house.gov/files/Fintech_Report_1.pdf.; see also "Agreeing in Advance to Lose? Legal Considerations in Regulating Confessions of Judgment," Congressional Research Service (Jan. 2019).

[8] See e.g., Matter of Cornerstone Tower Serv., Inc., No. A17-4050, 2019 WL 127359 (Bankr. D. Neb. Jan. 3, 2019).

[9] See e.g., Express Working Capital, LLC v. One World Cuisine Grp., LLC, No. 3:15-CV-3792-S, 2018 WL 4214349 (N.D. Tex. Aug. 16, 2018), report and recommendation adopted, No. 3:15-CV-3792-S, 2018 WL 4210142 (N.D. Tex. Sept. 4, 2018).

[10] See e.g., Fast Trak Inv. Co., LLC v. Sax, No. 4:17-CV-00257-KAW, 2018 WL 2183237 (N.D. Cal. May 11, 2018).

[11] See e.g., Fenway Fin., LLC v. Greater Columbus Realty, LLC, 995 N.E.2d 1225, 1232-33 (Ohio Ct. App. 2013).

[12] See e.g., Yellowstone Capital LLC v. Cent. USA Wireless LLC, 60 Misc. 3d 1220(A) (N.Y. Sup. Ct. 2018).

[13] See e.g., NY Capital Asset Corp. v. F & B Fuel Oil Co., 58 Misc. 3d 1229(A) (N.Y. Sup.

Ct. 2018).

[14] See e.g., In re Burm, 554 B.R. 5 (Bankr. D. Mass. 2016).

[15] See e.g., IBIS Capital Grp., LLC v. Four Paws Orlando LLC, No. 608586/16, 2017 WL 1065071, at *4 (N.Y. Sup. Ct. Mar. 10, 2017).

[16] See e.g., Coral Capital Sol. LLC v. Active Apparel Grp., No. 1004572011, 2011 WL 11076315, at *11 (N.Y. Sup. Ct. Sep. 22, 2011).

[17] See e.g NY Capital Asset Corp. v. F & B Fuel Oil Co., 58 Misc. 3d 1229(A) (N.Y. Sup. Ct. 2018).

[18] Notwithstanding, note that reconciling the merchant's monthly or weekly purchases with any fixed payments made by the merchant may weigh in favor of a sale and purchase arrangement if the credit risk is adequately shifted to the MCA provider.