BUSINESS LAW TODAY

Exploring the Legal Issues Relevant to Online Small-Business Lending

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The United States is home to more than 28 million small businesses. The businesses are diverse and range from sole proprietorships to companies that employ workers, produce goods or services in supply chains, or serve customers on Main Street. During and following the financial crisis, bank loans to small businesses fell 18 percent, exacerbating the credit crunch felt by small businesses. Accordingly, a number of new lenders, many of which leverage advances in technology and the availability of data to operate online, burst on the scene to serve the small-business market.

The new lenders emerged along three basic models. The first model, peer-to-peer marketplace lenders, connects prime and subprime small business borrowers with capital from individuals and institutional investors that are looking for a return on their investment. The second model, borrower-driven broker marketplaces, connects borrowers with traditional and alternative financing sources, from banks and SBA-backed loans to new online lenders. Finally, the third model, balance-sheet lenders, leverages capital provided by institutional investors that they hold on their balance sheet to make loan decisions based on proprietary risk-scoring algorithms that rely largely on cash-flow data.

Regardless of the model used to originate business credit, shared key legal issues emerged. We will explore some of the key legal issues that are unique to small-business lending, which include determining the purpose of the loan, whether certain consumer laws may apply, licensing and usury issues, electronic contracting issues, and Dodd-Frank Act considerations.

What Is a Business Purpose?

Determining what constitutes a "business purpose" for a loan is important because many federal and state laws apply only to loans originated for personal, family, or household purposes (i.e., a consumer purpose). The Truth in Lending Act (TILA) and its implementing regulation, Regulation Z, is the primary federal law regulating consumer credit. The TILA requires creditors to make disclosures to borrowers concerning the cost of the financing extended when the transaction is for a consumer purpose. The regulatory intent behind the TILA is to allow consumers to understand the true cost of the credit/money they are receiving and to facilitate easy comparison of credit terms across creditors.

The TILA and Regulation Z do not apply to extensions of credit primarily for a business, commercial, or agricultural purpose. In choosing to make the TILA disclosures, business lenders incur the risk of regulatory scrutiny in that a regulator may conclude a transaction has a primary consumer purpose. However, voluntary disclosure to a borrower is not without merit. TILA compliance, specifically in the form of fee transparency, can increase borrower confidence in a creditor's business practices and products. Given the competitive nature of the online lending space, this is a decision worth giving careful consideration.

If the borrower has characteristics of an individual consumer (such as loans to home-based businesses), determining the loan's primary purpose can be even trickier. The Official Interpretations to Regulation Z provide that "(a) creditor must determine in each case if the transaction is primarily for an exempt purpose. If some question exists as to the primary purpose for a credit extension, the creditor is, of course, free to make the disclosures, and the fact that disclosures are made under such circumstances is not controlling on the question of whether the transaction (is) exempt" from the TILA.

Regulation Z provides additional guidance as to the factors a creditor should consider to determine whether the credit is for a business purpose. For example, the borrower's statement of the purpose for the loan is a powerful factor that can potentially ward off claims that the transaction is for a consumer purpose. Other factors include the relationship of the borrower's primary occupation to the transaction—the more closely related, the greater the likelihood the transaction is for a business purpose. Outside of the suggestions in the Official Interpretations to Regulation Z, lenders can and should also try to look to other factors that showcase the strength and credibility of the small-business applicant. Business longevity, industry reputation and, if plausible, on-site visits are all valuable tools to analyze loan purpose, particularly for lenders that finance sole proprietorships.

Under the TILA and many state laws, the main risk with respect to the purpose of the loan comes when a lender makes a loan to a "natural person," including individuals and sole proprietorships. To the extent the borrower is a non-natural entity, like a corporation or a limited liability company, the TILA and many state laws do not apply.

Consumer Laws May Apply

Although consumer laws generally do not apply to business-purpose lending, significant exceptions do exist. For instance, some of the consumer laws that may apply to business-purpose lending include state consumer licensing schemes that define a "borrower" broadly to capture business borrowers. For example, some versions of the Uniform Consumer Credit Code (UCCC), such as West Virginia's adopted version of the UCCC, capture so-called agricultural loans, which are business-purpose. In addition, some versions of the UCCC provide rate regulation for different types of commercial-purpose transactions, such as Oklahoma's adopted version of the UCCC, which covers transactions that do not qualify as a "consumer loan" and provides that the annual percentage rate for an "other loan" (i.e., a commercial loan) cannot exceed 45 percent per year. Further, some state consumer-protection acts may define a "consumer transaction" broadly to include transactions that are personal, household, or business oriented. Finally, many substantive state laws will also apply to business-purpose loans, including state disclosure requirements.

In addition, the Equal Credit Opportunity Act (ECOA) and its implementing regulation, Regulation B, applies to business-purpose loans and includes explicit requirements for informing business applicants of adverse action when a lender denies credit and fair-lending standards. Finally, the Fair Credit Reporting Act (FCRA) may also apply in some instances to commercial credit transactions involving a consumer. Certain aspects of the FCRA, such as the requirement to have a permissible purpose to obtain a consumer's credit report and certain adverse action notice requirements, may apply when a lender "pulls" a credit report on an individual or a guarantor of a loan. One such example when it may apply is when the consumer is a co-obligor or a guarantor on the business-purpose loan.

Licensing and Usury Issues

An online lender, like any other nonbank lender, must observe all applicable state laws in each jurisdiction in which it lends. Chief among these laws are state-specific licensing and usury regulations, which are often intertwined with determining whether the online lender can offer a particular credit product to small businesses located in a particular state.

Many states do not require a license to engage in small-business lending. Certain states, such as North Dakota and California, however, have enacted licensing schemes where small-business lending activities are directly covered or may otherwise fall within the scheme's ambit. In those states, online lenders cannot lend to small businesses unless they obtain the appropriate license. In those cases, the online lender becomes subject to all of the requirements of a licensee; generally, the requirements may include limitations on fees, periodic reporting, surety bonds, disclosures, and/or vetting and oversight by state examiners.

Similarly, many states do not impose interest-rate limits on small-business loans (or do not impose such limits if the lender is properly licensed). In these states, lenders and small businesses are free to contract for an interest rate of their choosing. Other states, however, enforce a range of interest-rate limits. Within a single state, the interest-rate limits may vary based on certain attributes of a loan or a small business, such as loan size or small-business entity type. In addition, the interest-rate limits may provide separately for civil penalties and criminal violations, with significant differences in the consequences based on the type of violation.

A significant challenge faced by many online lenders in navigating the state-specific licensing and usury regulations is that they can often be inconsistent in scope and application. In some cases, overbroad or vague consumer finance statutes indiscriminately pick up many small-business loans where such restrictive protections are less, or not at all, appropriate. In other cases, overly restrictive interest-rate limits inadvertently squeeze credit availability by consigning local small businesses to rely entirely on credit products originated by banks, which can offer loans without the need to consider the interest-rate limits. In still other cases, outdated requirements, such as in-state, brick-and-mortar operations requirements, persist in regulations. As a result of these challenges, many online lenders have employed the following three approaches to offer a more consistent, uniform lending footprint to small businesses on a nationwide basis.

First, many online lenders originate their loans by partnering with a chartered issuing bank. The National Bank Act (NBA) and the Depository Institutions Deregulation and Monetary Control Act of 1980 respectively entitle federal- and state-chartered banks to export the laws of their home state for loans, regardless of the state in which the loan was made. Under the issuing-bank model, loans are typically originated in the following manner: (i) an online lender evaluates the creditworthiness of an applicant small business; (ii) if the loan application is approved for funding, the partner issuing bank originates the loan; (iii) the issuing bank retains the newly originated loan on its balance sheet for a minimum hold period; (iv) the online lender purchases the loan from the issuing bank for a specified fee; and (v) the online lender either holds or sells the loan, or an interest in the loan, to an investor. An online lender that purchases loans from issuing banks and their investors can, accordingly, rely on preemption of state-law claims for all loans originated and sold through the online lender. Recently, the issuing-bank model has been the subject of a number of high-profile court cases, including *Beechum v. Navient Solutions Inc.* and *Commonwealth of Pennsylvania v. Think Finance*. The model has been under additional scrutiny due to the U.S. Court of Appeals decision in *Madden v. Midland Funding LLC* in which the court held that non-national bank entities that purchase loans originated by national banks cannot rely on the NBA to protect them from state-law usury claims.

Second, outside of the issuing-bank model context, some online lenders rely on choice-of-law provisions to apply the law of a specific state to loans regardless of the location of the borrower. The state chosen may be the lenders' home state or another state with less restrictive usury laws. The tests applied by courts considering choice-of-law provisions in this context have differed state-to-state, but most courts typically have been willing to enforce the parties' contractual choice of law, unless there is no reasonable basis for adopting the laws of the chosen state, or such adoption would be contrary to a fundamental policy of the borrower's home state.

Nevertheless, a borrower or state regulator could seek to invalidate a choice-of-law provision and argue that loans may not lawfully be made at interest rates exceeding the maximum rate permitted under the usury laws applicable in the state in which the borrower is located. Given the fact-intensive analysis applied by courts, lenders fare better when the choice-of-law provision is clearly understood and agreed to by both parties, and the chosen state bears a substantial relationship to the loan transaction. It is important to note that the existence of a state licensing scheme often demonstrates a strong public-policy interest in favor of protecting borrowers located in that state. Accordingly, state licensing authorities generally conclude that a choice-of-law provision does not affect the licensing analysis, and instead a license is required if loans are made from within the state or are made to small businesses located in the state.

Third, some online lenders have designed credit products in a manner that results in characterization as something other than loans. Most state licensing and usury regulations apply solely to loans. Many courts have taken the position that a transaction will be deemed a loan only if the principal amount is repayable absolutely and is not contingent on any future circumstance of event. Common examples of such credit products are merchant cash advances or other agreements for the purchase and sale of future receivables. Courts, however, do have the ability to recharacterize alternative financial arrangements as loans on a case-by-case basis. Consequently, a product that is successfully recharacterized as a loan ultimately will be subject to the licensing and usury laws of the governing state.

Failure to have the appropriate license could result in severe consequences, including the voiding of originated loans. Consequences of contracting for an interest rate that exceeds the governing state law when a court sets aside a choice-of-law clause and/or recharacterizes a contract as a loan include voiding of the agreement, civil and/or criminal penalties, or other fines.

As of the date of this article, the Office of the Comptroller of the Currency has continued to work on a special-purpose, nonbank charter that would offer nonbank lenders a path toward federal preemption of state licensing and usury regulations. In addition, the Conference of State Bank Supervisors recently launched a series of initiatives called Vision 2020 aimed collectively at driving efficiency, standardization, and a convergence of supervisory expectations in state-based oversight of nonbanks.

Electronic Contracting Issues

It bears little surprise that online business lenders rely on electronic means for contracting and for storing records. The Electronic Signatures in Global and National Commerce Act (ESIGN Act) grants electronic documents and signatures the same legal weight as their paper counterparts, provided they meet the criteria outlined in the ESIGN Act.

The first and most important of the criteria is borrower consent. Creditors must obtain prior consent from the borrower before utilizing electronic contracting methods. In order to obtain consent, creditors must notify borrowers of the following:

1. the availability of paper records;
2. whether the borrower is consenting to electronic means for one specific transaction or to a class of records that may be provided over the entirety of the borrower-creditor relationship;
3. that the borrower can withdraw consent and any fees or conditions attached with withdrawal;
4. whatever hardware or software capabilities the borrower will need in order to access electronic records; and
5. how to obtain a paper copy upon request.

Borrower consent must be affirmative and not merely an opt-out.

In addition to consent, creditors must provide borrowers with post-consent disclosures of any significant changes the creditor has made to its means of storage that would change the hardware or software capabilities the borrower would need in order to access the records. Lastly, creditors must retain accurate records of the electronic transactions. Each record must reflect the information on the applicable contracts and records and must be kept for the period of time required by the applicable state and federal law for the record type.

Given that the ESIGN Act is federal law, it applies in all 50 states. The ESIGN Act does, however, permit states to modify, limit, or supersede it if the state has adopted the Uniform Electronic Transaction Act (UETA) or has created a law that is similar to it. To date, 47 states have adopted a version of UETA; only New York, Washington, and Illinois have not.

It is important to note that although many provisions of the Uniform Commercial Code (UCC) are exempt from the ESIGN Act, revised UCC Article 9 permits authentication or creation of security interests by electronic means. Under UCC Section 9-102, the UCC's definition of "authentication" is "to sign" or "with present intent to adopt or accept a record, to attach to or logically associate with the record an electronic sound, symbol, or process."

Section 1071 of the Dodd-Frank Act

In addition to granting the Consumer Financial Protection Bureau (CFPB) rule-making authority under various consumer-protection laws, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) also opened the door for the CFPB to extend its reach into business lending.

Enacted in 2010, Section 1071 of the Dodd-Frank Act tasked the CFPB with collecting data from "financial institutions." This task came by way of Section 1071's amendment to Regulation B, the implementing regulation of the federal ECOA.

The term "financial institution" is broadly defined under Regulation B as "any entity that engages in any financial activity." By this loose definition, business lenders fall under the scope of CFPB authority. Under Section 1071, financial institutions are required to report details concerning credit applications made by female-owned, minority-owned, or small businesses (a term that is not defined in Section 1071). The specific details are:

1. the number of the application and date received;
2. the type of credit for which the applicant applied;
3. the amount of credit for which the applicant applied;
4. the amount of credit for which the applicant was approved;
5. the gross annual revenue of the applicant; and
6. the race, sex, and ethnicity of the principal owner(s).

Section 1071 also requires financial institutions to keep information on an applicant's status as female-owned, minority-owned, or a small business away from underwriters and decision makers to the extent feasible. If an underwriter or decision maker must gain access to the information during the credit-evaluation process, the financial institution is required to notify the applicant concerning that access as well as the fact that the financial institution may not discriminate on the basis of that information.

As Section 1071 is written, business lenders are not only required to track the detailed data noted above, but also to maintain records of the data and report the data to the CFPB. Naturally, this will be a huge burden to many financial institutions serving the small business market that, like their clients, may be small businesses themselves. They, unlike their larger counterparts, may not have the administrative or technological resources to comply with Section 1071 demands, which places them at risk for potentially crippling penalties.

The CFPB held a field hearing on small-business lending in Los Angeles on May 10, 2017, and issued a Request for Information (RFI) Regarding the Small Business Lending Market. As stated in the RFI, the CFPB seeks to learn more about: (i) the small-business financing market, including understanding more about the products offered to small businesses (including women-owned and minority-owned small businesses), as well as the financial institutions that offer such credit; and (ii) the business-lending data that currently is used and may be maintained by financial institutions in connection with credit applications made by small businesses (including women-owned and minority-owned small businesses) and the potential complexity and cost of small-business data collection and reporting. Finally, the CFPB is also seeking comment from the public on privacy concerns related to the disclosure purposes of Section 1071. The comments to the RFI were originally due on or before July 14, 2017, but the CFPB later extended the comment period by 60 days to September 14, 2017.

As of the date of this article, the future of Section 1071's implementation is largely uncertain. Highlighting this uncertainty are calls for legislative repeal—ranging from financial reform recommendations issued by the U.S. Department of Treasury to legislation passed by the House Financial Services Committee to public stances of several prominent trade groups—as well as broader ongoing challenges to the authority of the CFPB. As a result, the impact of Section 1071 on business lenders also remains unclear.

Conclusion

Recent years have seen rapid growth in the number of new online lenders stepping in and serving the small-business market, which had experienced a marked decline in credit availability from banks. Regardless of the model used to originate business credit, whether a peer-to-peer marketplace lender, borrower-driven broker marketplace, or balance-sheet lender, the key legal issues that are unique to small-business lending discussed above should be reviewed in detail by the business lender for possible impact on its originations and operations.

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