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Merchant Cash Advance Overview

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Background: Merchant cash advance companies provide working funds to small to mid-size retailers and businesses (hereinafter simply referred to as "merchants") through a specialized form of factoring. The merchant cash advance company purchases receipts expected to be generated from a merchant's future sales. The merchant generally authorizes the merchant cash advance company to receive a certain percentage of its future daily sales receipts, or a fixed daily amount estimated to equal this percentage. The merchant either authorizes the merchant's credit card processor to send the agreed percentage of daily sales receipts directly to the merchant cash advance company or the merchant authorizes the merchant cash advance company to ACH the agreed amount from the merchant's checking account. These amounts are generally transferred each day until the merchant cash advance company has received all of the future receipts it has purchased.

The key to these transactions is that the merchant ***does not unconditionally agree to "repay" the advances.*** The merchant is only selling its future receipts to the extent the receipts are generated by the business. If the merchant does not generate sufficient receipts due to adverse business conditions, loss of leased premises, natural disasters or similar occurrences beyond the control of the merchant, the merchant cash advance company suffers the loss. The merchant, however, agrees not to engage in fraud or other practices that would intentionally deny the merchant cash advance company its purchased receivables. The owner of the merchant business generally guarantees that the business will not breach any covenants in the merchant cash advance agreement, but the owner is not an unconditional guarantor of repayment.

The merchant's obligation to deliver the future receivables is conditioned upon the continuance of the merchant's business. Thus, a merchant cash advance transaction is not a loan and not subject to the commercial usury laws and state licensing laws that apply to loan transactions. Common law generally recognizes that for an advance to be a loan, and thus to become a transaction subject to a state usury law or licensing requirement, the advance must be unconditionally repayable. If the obligation to repay is conditional – and the conditions are not illusory – then the transaction generally is not a loan. We are not aware of any state where this is not the common law rule.

In what has been called the "classic" description of whether a transaction is a sale or a loan, the U.S. Second Circuit Court of Appeals described the distinction as follows:

> A sale is the transfer of property in a thing for a price in money. The transfer of the property in a thing sold from a buyer to a seller for a price is the essence of the transaction. And the transfer is a transfer of the general or absolute property as distinguished from a special property.
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> A loan of money is a contract by which one delivers a sum of money to another and the latter agrees to return at a future time a sum equivalent to that which he borrows.

> In order to constitute a loan there must be a contract whereby, in substance one party transfers to the other a sum of money which that other agrees to repay absolutely, together with such additional sums as may be agreed upon for its use. If such be the intent of the parties, the transaction will be considered a loan without regard to its form.

In re Grand Union Co., 219 F 353, 356 (2d Cir. 1914) (internal citations omitted) (cited as the "classic definition of a loan" by *Cazenovia College v. Renshaw*, 222 F.3d 82 (2d Cir. 2000)).

Accordingly, so long as a merchant cash advance transaction does not require the merchant to "repay absolutely" the cash advance, the transaction should not be considered a loan. If a merchant cash advance transaction is deemed to be an unconditional promise to repay, a court may recharacterize it as a loan.

"Fixed ACH" Contracts. Many merchant cash advance companies have a "fixed ACH" program. Under a fixed ACH program, a merchant cash advance company purchases a certain amount of the merchant's future receivables and obtains authority from the merchant to collect a fixed amount each day from the merchant's checking account. The fixed daily ACH debit amount is intended to estimate the purchased percentage of the merchant's daily receipts. These programs also frequently include the purchase of the merchant's future cash receipts as well as credit card receipts. There is nothing in a fixed ACH program that should risk a court recharacterizing the transaction into a loan, provided that the merchant's obligation to repay remains conditional. The risk arises if the fixed ACH program appears to establish a fixed ACH debit schedule that would assure that the advance is repaid. A fixed ACH contract should include a monthly "true-up" in case the fixed daily ACH debits in any one month represent more than the "purchased percentage" of the total receivables the merchant generated during that month. A "true-up" provision typically provides that, if the total of the fixed daily ACH debits in any one month are different than the purchased percentage for that month, the merchant may request a correction resulting in a different daily ACH amount going forward that more accurately reflects the purchased percentage of the merchant's total monthly receivables. We believe that when used correctly, a fixed ACH program does not transform the purchase and sale of future receivables into a loan.

Merchant cash advance transactions in which the buyer purchases cash receivables and the merchant makes fixed ACH transfers have recently been tested by the courts, with mixed results. In *Pearl Capital Rivis Ventures. LLC v. RND Construction, Inc.*, a New York trial court found that a fixed ACH contract was a loan that violated New York's criminal usury law. [1] After granting Pearl's motion for a default judgment, the court held a hearing on the issue of damages and concluded that the transaction was a usurious loan. The court cited a number of factors, including the following:

- The contract listed a "total payback of $13,050.00" and Pearl's head of underwriting submitted an affidavit stating "that defendants began with a total of loaned funds of $13,050.00 against which they paid a total of $6,734.00";

[1] *Pearl Capital Rivis Ventures, LLC v. RDN Construction, Inc.*, No. 70590/15, 2016 WL 6245103 (N.Y. Sup. Ct. 10/25/16).

- The contract apparently lacked a true-up provision. The court refused to read Pearl's contract, because the contract was "illegible, with excessively small print;"
- The Court was "troubled" that Pearl was able to escape an element of risk of non-payment by deeming a borrower's failure to pay to be willful or otherwise unjustified, and entitling it to seek payment in full under a personal guaranty provided by business owner;
- Pearl was unable to point to a non-recourse provision in the contract. Pearl's chief risk officer's testimony featured only general instances, such as a flooded warehouse, under which Pearl might not be able to collect repayment.

The court calculated that the interest rate under the contract was 180% per annum. As a result, the court held that Pearl could not recover principal or interest, or any of its fees or costs.

In another case, *Merchant Cash & Capital LLC v. Edgewood Group*, the U.S. District Court for the Southern District of New York commissioned a report from a U.S. Magistrate Judge on the applicable damages under a cash advance agreement with a daily ACH program. The Magistrate Judge noted that the agreement had troublesome language, including that the "Purchased Percentage" of receivables was left blank – only indicating "%." In a footnote, the Magistrate Judge states that the agreement looks very similar to a loan, especially because a purchased percentage was not specified. Nevertheless, the judge declined to conclude that the transaction was a loan as a matter of law, citing *Starving Students* and looking to the "attendant circumstances." As a result, the Magistrate Judge found the contract sufficient to establish that the merchant owed a duty to deliver the purchased receivables. The Magistrate Judge recommended, and the district court subsequently ordered, significant contractual damages reflecting the validity of a merchant cash advance agreement with a daily ACH program.[2]

Despite the problematic facts in *Pearl* and *Edgewood Group*, a fixed ACH program should not be considered a loan when the contract is properly drafted. If the obligation of the merchant remains conditional, and this conditional nature is not contradicted by the actions of the merchant cash advance company, the transactions should not be recharacterized as loans.

Recharacterization Challenges in California: The merchant cash advance industry faced a series of class action lawsuits in California. Some of these cases settled once the plaintiffs were able to show that documentation for these transactions used loan terminology, or that owners had signed broad repayment guarantees. Other cases settled because collectors acting for merchant cash advance companies were demanding repayment of the advances even when the merchants had not breached the merchant cash advance agreements and had legitimate reasons why their credit card receipts had been insufficient to provide the merchant cash advance companies with all of the future receivables that had been purchased.[3] Other merchant cash advance companies that included effective mandatory

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[2] *Merchant Cash & Capital LLC v. Edgewood Group, LLC*, No. 14CV03497 JGK DF, 2015 WL 4430643 (S.D.N.Y. July 2, 2015) report and recommendation adopted, No. 14 CV. 3497 JGK DCF, 2015 WL 4451057 (S.D.N.Y. July 20, 2015).

[3] *See, for example, Clark v. AdvanceMe Inc.*, Case No. 2:08-cv-03540 VBF-FFM (C.D. Cal. 2010) (AdvanceMe paid $11.5 million to settle the allegations and agreed to implement measures to protect merchants when their future receivables fell short for legitimate reasons.) and *Bistro Exec., Inc. v. Rewards Network, Inc.*, 2006 U.S. Dist. LEXIS 100770 (C.D. Cal. 2006) (The court found that defendant's prior pleadings in

arbitration provisions in their contracts were able to defeat the class certification motions in these cases.

The merchant cash advance industry responded to the California lawsuits in four ways. First, because California law does not limit interest rates for most loans of $2,500 or more made by a licensed entity,[4] merchant cash advance companies began obtaining California Finance Lenders Law ("CFLL") licenses. Once a merchant cash advance company has a CFLL license, even if the transactions are recharacterized as loans, the transactions are not usurious under state law.

Second, most merchant cash advance companies that did not use mandatory pre-dispute arbitration clauses began to include them in their contracts.[5] Other merchant cash advance companies began using class action waiver clauses.[6]

Third, many companies added language to their contracts similar to the following provision that AdvanceMe (now CAN Capital) agreed to include as part of its settlement of a California class action:

> Buyer, Seller and Principals acknowledge and agree that Seller going bankrupt or going out of business, in and of itself, does not constitute a breach of the Seller Contractual Covenants.

Finally, merchant cash advance companies also responded to the California lawsuits by reviewing their documents and practices, including their collection tactics, and correcting any documents or practices that would suggest the advances were unconditionally repayable or otherwise were considered loans.

Recharacterization Challenges in Other States: Recharacterization challenges have been brought in a few other states following the California lawsuits. In 2014, a merchant cash advance

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collection cases characterizing the transactions as "loans" prevented the defendant from claiming otherwise in this case).

4 Cal. Fin. Code §§ 22370; 22303. Please note that commercial loans of $5,000 or more have fewer restrictions. Cal. Fin. Code §§ 22502; 22550.

5 *See Captain Bounce, Inc. v. Business Financial Services, Inc.*, 2012 U.S. Dist. LEXIS 36750 (S.D. Cal. March 19, 2012) (This case is an example of a merchant cash advance company using an arbitration clause to defeat class certification. The district court explained that contracts in California must be both procedurally and substantively conscionable. When reviewing the procedural conscionability of the mandatory arbitration term, the district court found the business-to-business context relevant, because the parties are viewed as sophisticated negotiators who understand the terms. The merchant was given the opportunity to negotiate terms and review the agreement. The district court also explained that terms limiting punitive damages, requiring a forum for arbitration, and allocating arbitration costs to the merchant were not substantively unconscionable.

6 *See Math Magicians, Inc. v. Capital for Merchants LLC*, 2013 Cal. App. Unpub. LEXIS 8694 (Ca. Second App. Nov. 26, 2013) for an example of the use of a class action waiver clause.

company defeated a claim that the transaction was a loan subject to Texas usury law.[7] In most cases, merchant cash advance companies have prevailed in this litigation.[8] However, in 2007, the Supreme Court for New York County found two contracts labeled as "advanced sales" to be loans. The court found the transactions were absolutely repayable because any default (including bankruptcy or the closing of the business) would trigger payment in full.[9] The court was also troubled because the

[7] *Express Working Capital, LLC v. Starving Students, Inc.,* 28 F.Supp. 3d 660 (N.D. Texas June 24, 2014) (The U.S. District Court for the Northern District of Texas found that a purchase and sale of future credit card receivables was not a loan or subject to Texas usury laws. The district court noted that under sections 306.103 and 306.001 of the Texas Code, "if the parties intend to enter a transaction to sell accounts at a discount and characterize the transaction as such, 'it cannot be a loan or line of credit' and any discount charged under such a transaction is not interest." (*Citing Korrody v. Miller*, 126 S.W.3d 224, 226). Because the distinction between a loan and an account purchase transaction can be blurred, courts in Texas must "ascertain the intention of the parties as disclosed by the contract, the attending circumstances, or both." The district court explained that the presence of recourse provisions in the contract or taking a security interest in a merchant's property does not make an agreement a loan under the Texas Code. The district court found the contract's terms and description as a "Non-Loan Advance" and "Future Receivables Sale Agreement," along with the business relationship between the parties, indicated that the parties intended to enter into a series of account purchase transactions.")

[8] *See Merchants Advance, LLC v. Tribeca*, Supreme Court, State of New York, Nassau County (Case No. 004214/2008) ("not only does the Agreement lack the necessary elements of a loan transaction, but also the parties themselves agreed that plaintiff paid a purchase price for future credit card receivables."); *In re Karakosta Investments, Inc*, Case No. 9:08-bk-09024-ALP (Bankr. M.D. Fla. 2008) (finding that the transaction was a sale and not a loan because "[t]he Agreement fails to provide for recourse against the Debtors. If the Debtors cease to operate, there is no right to collect any amount from the Debtors.") In a later opinion the court vacated that decision and clarified that for purposes of the bankruptcy, because Karakosta Investments, Inc. did not have a vested property interest in future receivables, the transaction was an "attempted sale." However, the court did not change its conclusion that the transaction was not a loan.; *Strategic Funding Source, Inc. v. AR Dental Supply Corp. et al.*, Supreme Court, State of New York, Kings County (Case No. 29923/08) (holding that the repayment to Strategic Funding was "genuinely at hazard" because it depended on the amount of credit card receivables AR Dental received month-to-month.); *Professional Merchant Advance Capital, LLC v. Your Trading Room*, Supreme Court, State of New York, Suffolk County (2012 N.Y. Misc. LEXIS 6757; 2012 NY Slip Op 33785) (where the court declined to apply the defendant's usury and other defenses because he signed an agreement to sell future receivables. Importantly, the court applied New York jurisdiction despite the defendant's claims that he was not a New York citizen or made any action that would subject himself to New York law. The court found that proof of one transaction in New York is sufficient to establish jurisdiction, and purposeful activities of a party may subject himself to New York jurisdiction. In this case, the defendant's performance guarantee included an obligation to deposit daily credit card receivables in a bank account in New York.); *Merchant Cash & Capital, LLC v. Yehowa Med. Servs., Inc.*, No. 602039-16 (N.Y. Sup. August 2, 2016) (rejecting usury defense because payments were based on receipts; the court also noted that there was no absolute obligation of repayment); *Platinum Rapid Funding Group LTD v. VIP Limousine Servs. Inc.*, No. 604136-15 (N.Y. Sup. June 10, 2016) (rejecting usury defense because the plaintiff took risk the that there would be no receipts and the defendant risked that receipts would be higher than anticipated causing repayment to happen in abbreviated period; the court also noted that converting agreement to a loan would contradict the explicit terms of agreement).

[9] *Clever Ideas, Inc. v. 999 Restaurant Corp.*, 2007 NY Slip Op 33496 (Oct. 17, 2007).

transactions were secured by a security interest in the property of the business and a personal guarantee of the owner. However, we believe that taking a security interest in business assets and obtaining a guarantee of performance (but not of payment) from the business owner should not, in themselves, cause a merchant cash transaction to be recharacterized.

A personal guaranty may also contain waivers of defenses that may be helpful to a merchant cash advance company in its efforts to obtain the receivables it is entitled to under an agreement. A New York court upheld a personal guaranty signed in conjunction with a factoring agreement that made the guarantor personally liable for any obligation under the contract, and also contained broad waivers of all defenses, set offs, counterclaims or cross claims.[10]

Regulatory Responses: We know of no adverse federal regulatory response targeting merchant cash advance as an industry. Nevertheless, the factor rates imposed on these transactions may cause some calls for regulation. At the federal level it is not clear where the regulatory impetus for such action would come. The jurisdiction of the Consumer Financial Protection Bureau ("CFPB") is generally limited to consumer-purpose transactions. The CFPB does not have the authority to regulate commercial factoring or lending, although the Bureau does have the right to require certain business lenders to collect certain borrower demographic information pursuant to the Dodd-Frank Act.[11] The CFPB also has authority to enforce the Fair Credit Reporting Act, which requires a permissible purpose to obtain a consumer credit report on an individual (such as a guarantor),[12] and the Equal Credit Opportunity Act, which applies generally to "credit", including commercial lending.[13] The CFPB may attempt to extend this authority to companies that offer merchant cash advances.

The Federal Trade Commission ("FTC") has the authority to regulate unfair commercial practices. We see no reason the FTC would view the merchant cash advance model itself as something that should be prohibited. The FTC generally has not viewed the high cost of a particular product as an illegal or deceptive practice. Rather, the FTC has looked to see how a high-cost product is being sold to ensure that no deceptive practices are used in the sales pitch.

The FTC could begin investigations if it found providers were mischaracterizing their product offerings or otherwise engaging in unfair or deceptive practices. The FTC took action against Merchant Services Direct, LLC, an independent sales organization ("ISO") that sold credit card processing services.[14] In court filings and its press release, the FTC alleged that the ISO advertised on its web site

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[10] *RMP Capital, Corp. v. Victor Jet, LLC*, 2013 N.Y. Misc. LEXIS 1740. 2013 NY Slip Op 30875 (April 12, 2013) (explaining that the defendant merchant's defenses of usury, material breach of the plaintiff under the factoring agreement, and the invalidity of the factoring agreement were "wholly unavailing" because of the waiver in the written guaranties).

[11] *See* Dodd–Frank Wall Street Reform and Consumer Protection Act (Pub.L. 111–203, H.R. 4173), Section 1071.

[12] *See* 15 USC § 1681b.

[13] *See* 15 U.S.C.A. § 1691a.

[14] *Federal Trade Commission v. Merchant Services Direct, LLC*, Case #: 2:13-cv-00279-TOR (E.D. Wa. 2014), *available at* https://www.ftc.gov/system/files/documents/cases/141125merchantstip.pdf.

that it had "Guaranteed Lowest Rates," claimed merchants could "save 30%" with "whole sale [sic] processing" or have "anywhere from 20% to 30% savings when switching to" its service. Claiming that these advertisements were "unsubstantiated," the FTC asked the U.S. District Court for the Eastern District of Washington for an order freezing business's assets and to stop the allegedly deceptive acts and practices. Merchant Services Direct denied the FTC's allegations regarding the alleged deceptive advertising.

In the *Merchant Services Direct LLC* stipulation and order, the defendants agreed to no longer misrepresent any material fact regarding its services, and to take the following steps to monitor compliance:

1. Establishing and maintaining a procedure for receiving and responding to merchant complaints;
2. Ascertaining the number and nature of merchant complaints regarding transactions in which each employee or sales agent is involved;
3. Promptly investigating fully any merchant complaint received; and
4. Taking corrective action with respect to any sales agent or employee whom does not comply.

The *Merchant Services Direct* stipulation also required the ISOs to provide merchants with a "separate document setting forth all fees, charges, and rates to be assessed or debited in connection with any contracts."

Any regulation of the merchant cash advance industry more likely will come at the state level. However, given the lack of alternative funding sources for small businesses, we do not anticipate a rush to limit the availability of merchant cash advance transactions. At most, we would expect one or more states to impose some limits on the terms of merchant cash transactions, including perhaps, limits on discount rates. However, we know of no state legislative efforts in this area at the moment.

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