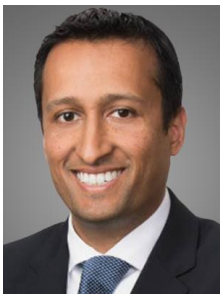
Loper Fuels Debate Over Merchant Cash Advances As Credit

By **Moorari Shah, Mehul Madia and Beineng Zhang** (August 13, 2024)

Moorari Shah



Mehul Madia

Beineng Zhang

In December 2023, the Revenue Based Finance Coalition, a trade association whose members provide funding to small businesses, filed suit in the U.S. District Court for the Southern District of Florida, challenging rulemaking by the Consumer Financial Protection Bureau under Section 1071 of the Dodd-Frank Act.[1]

The final rule requires lenders to collect and report extensive data in connection with credit extended to small businesses.

The RBFC's chief contention in seeking to set aside the final rule is that the CFPB exceeded its authority in defining "credit" in a manner inconsistent with the Equal Credit Opportunity Act. Specifically, the bureau wrongly included merchant cash advances, or MCAs, a form of small business financing, in that definition.

In the wake of the U.S. Supreme Court's June decision in Loper Bright Enterprises v. Raimondo, the RBFC believes its position has been bolstered.[2]

By contrast, the bureau believes the final rule implementing Section 1071 is entirely consistent with the statutory definition of credit, such that Loper is immaterial.[3]

Both the RBFC and CFPB have submitted briefs seeking summary judgment, and regardless of the district court's resolution, an appeal may well be the next step in a potentially protracted litigation battle, even as the first compliance date is tentatively set for mid-2025.

What is a merchant cash advance?

According to the "Small Business Credit Survey: 2022 Report on Employer Firms" conducted by 12 reserve banks of the Federal Reserve System, MCAs, sometimes referred to as sales-based financing, have gained increasing popularity in recent years, with more than 8% of small businesses indicating that they have applied for, and regularly use, MCAs as of 2021.[4]

Under an MCA, a small business receives a lump-sum payment in exchange for the provider receiving a fixed amount of future receivables from the business. The merchant typically sells a percentage of its future revenue, such as a percentage of daily credit card receipts, or agrees to pay a fixed periodic amount to the MCA provider based on sales.

The MCA industry has historically argued that MCAs are not credit, drawing parallels to factoring arrangements, which have been specifically scoped out of federal credit laws. For example, the staff commentary to the ECOA excludes factoring transactions because they involve the "purchase of accounts receivable."[5]

No distinction is made in Regulation B between existing and future receivables, and in keeping with the bureau's interpretation, many courts have found that sales-based financing

transactions were not loans.[6]

On what basis did the CFPB deem MCAs to be credit?

While the potential of MCAs to be recharacterized as loans has always existed based on how they were structured, the CFPB rulemaking categorically sets forth that all MCAs are, in fact, loans and subject to its small business data collection rule.

The rule requires lenders to collect and report certain data related to business applications for credit. Among the reasons for including MCAs was the concern about the higher frequency of their use among minority-owned businesses, coupled with reports of problematic provider practices.

A February 2020 Federal Trade Commission report showed that the industry tended to cater to higher-risk businesses or owners with low credit scores, offering them higher-cost products.[7]

Is the CFPB's determination correct as a matter of law?

In its challenge, the RBFC contends that MCA transactions involve a substantially contemporaneous exchange of value — i.e., rights to a percentage of revenue generated by a business's sale of goods and services in exchange for financing reflecting the discounted present value of those anticipated revenues.

Merchants have no right to defer payment of the agreed-upon portion of sales receipts when they generate revenue. Second, MCAs do not involve debt because merchants have no liability or obligation to repay the advance if future receipts do not materialize. Unlike creditors, MCA providers do not have an enforceable right to payment if a business fails.

The bureau has disagreed. It argues that MCA providers do grant merchants the right to defer repayment to a later date, one of the hallmarks of credit. This differs from factoring transactions — which the bureau acknowledges are not credit transactions — because they are the sale of accounts receivable already owed to the merchant.

Moreover, MCAs are debt because they create an obligation to repay, i.e., it is not free money. And even if the merchant's payment obligation is contingent on the business making money, that does not mean that a debt has not been created.

The CFPB notes there are many types of debts that make repayment contingent on a termination event, i.e., a reverse mortgage through the death of a homeowner. Finally, the bureau highlighted in its rulemaking that MCA products are underwritten and function like a typical loan, i.e., underwriting of the recipient; repayment of the advance itself plus additional amounts, which is similar to interest.

Does the Supreme Court's rejection of Chevron **enhance the RBFC's case?**

The Supreme Court's Loper decision, which overruled Chevron deference, marks a significant shift in the judicial review of agency actions. By requiring courts to exercise their independent judgment in interpreting ambiguous statutes, without deferring to agency interpretations, the decision limits the ability of agencies to change legal interpretations without clear congressional authorization.

For the RBFC, the ostensible lack of any historical precedent or prior pronouncement by the

CFPB for the position taken by the CFPB that MCAs are credit under ECOA provides an opening to argue that the final rule should be set aside as applied to sales-based financing.[8]

Further, the federal district court hearing the RBFC's challenge may find the bureau's distinction — that factoring arrangements do not constitute credit, while MCAs do — irreconcilable, as both transactions typically involve a preestablished protocol for the ongoing sale of receivables by a merchant to a funding source.

What actions should MCA providers consider in the near term?

While the industry awaits the federal district court's decision and a possible appeal, there are some immediate takeaways for MCA companies in the wake of Loper.

The Demise of Chevron Has Not Deterred the CFPB

The bureau's view of what constitutes credit is ever-expanding. Just this past year, it has asserted that income share agreements[9] and large bank discretionary overdrafts are forms of credit.[10]

Accordingly, while the bureau is actively litigating challenges to its Section 1071 rulemaking,[11] the bureau's enforcement posture under various federal laws should not be underestimated in its continuing efforts to rein in discriminatory lending practices.

Risk Management and Transparency

MCA providers may wish to proactively address the issues the CFPB highlights regarding the lack of transparency, high default rates and potentially predatory practices and fair lending concerns within the MCA market.

Among other things, funders should reevaluate the clarity of communications with merchants regarding the terms, costs and nature of MCAs. This reevaluation could also involve scrutinizing contract language and marketing materials to ensure they accurately reflect the purchase-and-sale nature of the transactions and comply with existing state laws and regulations.

Preparation for Compliance and Reporting Requirements

With federal regulation still uncertain, state regulators are attempting to fill the gap. Sixteen states have either enacted or considered commercial financing disclosure laws that define specific disclosure requirements for sales-based financing.

California was among the first states to also add a reporting obligation for commercial financing transactions made to small businesses, which appears likely to be replicated in other states.[12]

Accordingly, MCA providers should prepare for compliance and reporting requirements similar to those of traditional lenders, including investing in systems and processes for data collection, analysis and reporting, as well as developing a compliance program.

Moorari Shah is a partner and leader of the consumer finance team at Sheppard Mullin

Richter & Hampton LLP.

Mehul Madia is special counsel at the firm.

Beineng Zhang is an associate at the firm.

[1] Revenue Based Finance Coalition v. Consumer Financial Protection Bureau, No. 1:23-cv-24882 (S.D. Fla. filed Dec. 26, 2023); see also 15 U.S.C. 1691 et seq.

[2] Loper Bright Enters v. Raimondo, 144 S. Ct. 2244 (Jun. 28, 2024); see RBFC's Notice of Supplemental Authority filed July 18, 2024.

[3] See CFPB's Response to Notice of Supplemental Authority filed on July 25, 2024.

[4] Federal Reserve, Small Business Credit Survey: 2022 Report on Employer Firms (2022), https://www.fedsmallbusiness.org/reports/survey/2022/2022-report-on-employer-firms.

[5] See Equal Credit Opportunity Act, Regulation B, 12 C.F.R. pt. 202, supp. I, § 202.9(a)(3)-3 (1990).

[6] See, e.g., Womack v. Cap. Stack, LLC, 2019 WL 4142740, at *5 (S.D.N.Y. Aug. 30, 2019) (collecting state and federal cases).

[7] Fed. Trade Comm'n, 'Strictly Business' Forum, Staff Perspective, at 6-8 (Feb. 2020), https://www.ftc.gov/system/files/documents/reports/staff-perspective-paper-ftcs-strictly-business-forum/strictly_business_forum_staff_perspective.pdf.

[8] See Loper, noting that an agency's judgments and interpretations may still be considered by courts, but "[t]he weight of such a judgment in a particular case. . . would depend upon the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade, if lacking power to control."

[9] See Consent Order, BloomTech Inc. (d/b/a Bloom Inst. of Tech. or BloomTech, f/k/a Lambda, Inc.) and Austen Allred, CFPB No. 2024-CFPB-0001 (Apr. 17, 2024).

[10] Consumer Financial Protection Bureau, Overdraft Lending: Very Large Financial Institutions, 89 Fed. Reg. 13,852 (proposed Feb. 23, 2024) (to be codified at 12 C.F.R. pt. 1042).

[11] See, e.g., Texas Bankers Ass'n v. CFPB, No. 7:23-cv-00144 (S.D. Tex. filed Apr. 26, 2023); The Monticello Banking Co. v. CFPB, No. 6:23-cv-00148 (E.D. Ky. filed Aug. 11, 2023).

[12] See Cal. Code Regs. tit. 10, § 1062. Draft legislation proposed in Illinois contemplated a similar reporting requirement.