The Keys to Dealing with Intensifying Regulations for Commercial Finance Companies

In part two of a two-part series, Steven N. Kurtz, Esq., provides advice on how factors and asset-based lenders can avoid the pitfalls of increasing commercial finance regulations.

We are now faced with the reality that non-bank commercial finance companies are going to be subject to increased regulation. While this two-part article has mostly focused on state regulation, it is also important to know that there may be a trend toward some federal regulation.

There are rumblings that the Dodd-Frank Act may be modified to include factoring transactions. Also, federal agencies such as the Office of the Comptroller of the Currency may soon take actions that impact the factoring industry.

One indicator of how the Biden administration may address commercial finance lenders will be how the OCC handles the multiple lawsuits brought against it by seven states and the District of Columbia challenging the "True Lender Rule." This provision allows non-bank lenders to originate loans through state or federally charted bank partners in which the bank is the lender per the loan contract. This structure eliminates state law regulation of commercial finance lender loans made in partnership with a bank. If the OCC does not vigorously defend the True Lender Rule, it may mean that things will change for the factoring industry at the federal level.

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With more regulation on the horizon, this follow-up to part one of this article intends to provide some tips on minimizing the impact through provisions in factoring agreements.

IMPROVE DOCUMENTATION

State regulatory power and licenses usually give the state the ability to conduct audits. In California, state audits of finance lenders license holders are common. This will likely be the case under New York's new rules. Therefore, documentation with an eye toward new laws, administrative regulations and state audits is now an important issue.

The current regulatory schemes in New York and California mostly came about because of merchant cash advance lenders. In addition to routinely charging rates of return in excess of 70%, the actual rates from these lenders are usually very difficult to determine unless you are a quantitative analyst. Easy money coupled with astronomical effective interest rates and confessions of judgment have resulted in numerous defaults in which a small business-person or sole proprietor did not know to what they agreed.

The regulations on the horizon and the examiners who will enforce these rules will be zeroing in on rate disclosures and calculations. While factoring and asset-based lending transaction cost of funds for each advance will vary, mostly depending upon when the advance is repaid, factoring and ABL rates are relatively easy to quantify. Each separate cost of money in the agreement needs to be itemized, defined and explained. In factoring deals, it's easy to have a fee section tied to a chart that explains how each and every fee is calculated. If the agreement is subject to "float days" or deferred credit, it is critical to explain that. It's also important to explain in the agreement that the account activity is always available online if there is no event of default. You don't want to help fraudsters steal and divert accounts by looking online after fraud is discovered. You also need language that provides that the factor client/borrower has a limited time period in which it can dispute its account; otherwise, the stated account becomes binding. State auditors typically like to take sample deals and ask for copies of the contracts and detailed information on advances and collections. From there, they will seek to find fault in applying credits and insist upon refunds being made. Plain English explanations coupled with these protections are likely to satisfy a state auditor's inquiries on rate calculation and credits.

CLEARLY DEFINE WORKING CAPITAL NEEDS

State auditors and regulators tend to think of factor clients and ABL borrowers as consumers even though factoring and asset-based lenders provide financing to businesses. In California, there has been a trend with state regulators to isolate factoring and ABL advances under $5,000 and call out the factor/lender for failure to include certain disclosures required in "micro consumer loans." In fact, many states treat small advances to businesses as consumer loans. This trend means that even though you may have a revolving facility of $1 million with varying advances depending on the client's needs, each individual advance under your facility may be treated by the auditor as a separate loan. The effect of this skewed view is that a state auditor will treat the small advance as a consumer loan, including all related disclosure rules. Thus, it is important that the "look and feel" of your agreement makes it clear that the deal is a working capital line of credit. While all factoring and asset based-lending documents are obviously structured as business deals, because regulators will likely get their hands on the agreements, it makes sense to have some recitals that the client is a business seeking working capital through the facility.

In addition, many state and federal laws that address consumer lending allow for a statement that provides that a transaction is not for personal or household purposes, and lenders are allowed to rely upon that statement. For smaller deals, this clause is important. It's not uncommon for some of the smaller factoring deals, especially in transportation, to finance an individual. Given the trend toward treating small business financing deals as consumer transactions, it's best to insist that a sole proprietor form a corporation or an LLC. A small business owner can do so swiftly and at little expense.

EXPAND DAMAGE WAIVERS

Unfortunately, new regulations often come with the potential for litigation. While it's not certain whether individual factor clients or borrowers can state claims for violations of the new laws and corresponding regulations (which are typically enforced by government agencies), a viable argument can be made on the grounds that the laws and resulting regulations were drafted for the benefit of debtors. Therefore, a creative lawyer may claim that the factor/lender can and should be held accountable for violations to the party who is the "beneficiary" of the laws and regulations. This is where contractual limitation of damages comes into play. Most traditional damage waivers address a breach of an agreement and include language that precludes punitive damages (probably not enforceable if one is guilty of such conduct) and limits the breach of contract claims to actual losses that flow from a breach.

Damage waivers should be expanded not only to include a breach of the agreement by the factor/lender, but a mandatory