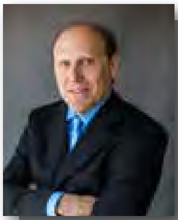
Regulation of Commercial Finance Companies is Here and Intensifying

In part one of a two-part series, Steven N. Kurtz, Esq., details the increasing push for regulations at the state level for commercial finance companies, including factors.

Until recently, non-bank lenders have escaped regulation, with the exception of those in California. Although California has had a long established regulatory scheme for non-bank lenders, in the past, those regulatory efforts were relatively minor. For years, non-bank lenders, including factors, obtained a California finance lenders license and in exchange for a small fee every year and minor reporting, were granted a safe harbor from California's strict usury laws.



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The times have changed for the commercial finance industry and regulation has intensified, primarily at the state level. Although there was an effort by the federal government to include factors in shadow banking regulation, this never happened, in part, through the efforts of the American Factoring Association. However, thanks to several years of merchant cash advance lenders extending credit to anyone with a pulse and bank account while charging 70% plus rates of return and enforcing New York contractual confession of judgments, lawmakers throughout the country woke up. Now, non-bank lenders, including factors, will be the subject of additional efforts to regulate.

State legislators are looking into all forms of non-bank lending. This includes factors who engage in traditional non-recourse deals, which, according to most case law, are true sales and not loans. The lending versus true sale argument for purposes of regulation is now irrelevant. The pending laws just look at one thing: Do you extend money to someone and expect to be repaid? If the answer to this question is yes — and it always is — then the regulations apply.

The new trend of regulation at this point is primarily at the state level, but it could easily be subject to federal regulation under the Commerce Clause of the U.S. Constitution. For now, we can expect states to focus on two primary forms of regulation: First, holding a lending license with the particular state, which subjects the license holder to the ever-expanding set of rules which govern license holders. The second area of focus will be rate and financing cost disclosures. You will be required to state how much a typical funding will cost, which can be challenging and subject to confusion for everyone concerned. These rules also will likely work with each state's laws on usury.

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California is the first state to require a finance lenders license for all non-bank lenders or factors. The law is based upon the California State Constitution, which sets a maximum rate of interest at 10%, then branches out to a patchwork of different statutes and regulations. For years, California just focused on licensing. The licensing and its one-time sleepy enforcement were handled by the Department of Corporations and then by the Department of Business Oversight. However, under Governor Gavin Newsom, the Department of Business Oversight has been reorganized and is now known as the Department of Financial Protection and Innovation, whatever that means. This change is so recent that forms have not yet been modified and it's not clear what the acronym will be. I'm guessing it will be the DFPI.

The DFPI is headed up by Manny Alverez, who served with the Consumer Financial Protection Bureau. If you are a non-bank lender, including a non-recourse factor, the DFPI will expect you to have a license regardless of the rate charged or whether the transaction can hold up in court as a true sale. The mere act of financing by a non-bank will trigger the requirement for a finance lenders license. The finance lenders license subjects the holder/applicant to background checks, financial net-worth requirements and periodic audits (a different conversation). The license holder is exempt from California's usury law, which is 10% and coupled with stringent civil penalties in favor of the borrower as well as civil, administrative and criminal penalties in favor of the state.

The second piece of California's regulatory framework for non-bank lenders is that for every offer of commercial financing of $500,000 or lower, the offer must include a statement that reflects how much the financing will cost. For factoring and other forms of financing where advancing funds — and the collection thereof always varies — the lender cannot give an example of a typical financing. This new law has been on California's books for nearly two years but will not go live until the DFPI prepares its accompanying regulations. These regulations are nearly finished and may even be in place by the time this article is published.

New York recently passed two pieces of legislation that are substantially similar to the scheme in California, including its own licensing law as well as a business truth in lending law. The licensing rules are set forth in Senate Bill S6688, which is waiting for Governor Andrew Cuomo's signature, and will require all non-bank lenders to obtain a license. The licensing scheme will include the usual things, such as background checks and capital requirements. However, there is more. New York will not allow confession of judgments to be executed in connection with a non-bank loan. There is a safe harbor for lenders that enter into or solicit fewer than five transactions in a 12-month period. While this safe harbor may be helpful to a lender or factor outside of New York, the

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solicitation language is troubling and can sweep up almost any communication. Also, it is likely that a New York regulator may take a tip from a California regulator and consider each advance under a revolving line of credit or factoring agreement to be a separate loan. If a lender violates Senate Bill S6688, the loan is void, meaning that the borrower/factor client does not have to pay it back.

In addition, New York passed a business truth in lending law, known as S5470A. This rule is similar to California's rule and requires a financing cost disclosure at the inception for all finance offers under $500,000.

Not to be outdone, the legislature in New Jersey put together Senate Bill 3616, which appears to have died in committee. This effort (and the drafting) shows what can happen when legislators who are not friendly to business come together and regulate. The purpose of the law was to target "alternative business loans," which are loosely defined as loans that rely on non-standard credit approvals, interest rates of greater than 25%, maturity of fewer than two years and payment frequency greater than bi-weekly. This law would have required licensing for all alternative lenders and brokers and detailed disclosure on what and how brokers are paid. In addition, the law had continuing education requirements for the alternative lenders as well as requirements that all new employees receive education. The law also would have required that all litigation for alternative lenders against the borrower be commenced solely in New Jersey. This proposed law would have likely caused many factors and asset-based lenders to retreat from the state, and it seems that the drafters and sponsors did not understand or care.

The regulation of non-bank lenders is a trend that is growing. This will probably be a red state versus blue state issue, and it's highly likely other states will follow California and New York's lead. The most likely result will be licensing requirements and disclosure requirements. Although factors and asset-based lenders have mostly operated outside the regulatory scope, simple licensing and rate disclosures, which are challenging, are things with which they can live. Problems will arise if states try to enact something along the lines of what failed in New Jersey. In addition, each set of state laws also will result in an accompanying set of regulations. If states legislate and regulate beyond licensing and rate disclosures, or give an enforcement group wide latitude similar to what is happening in California, factors are in danger of having to operate in a patchwork of different and contradicting state laws.

Right now, factors and asset-based lenders operate nationally and are protected by the Uniform Commercial Code, which, with the exception of a few provisions, is the same in every state. The UCC is set up so that its rules govern commercial transactions and that the terms of a security agreement bind the debtor and all creditors. There is a real possibility that laws or regulations may be enacted which contradict the UCC, which will result in messy litigation. Also, there is the danger that state regulators will start to take away the benefits of financing contracts, setting up potential constitutional challenges.

The trend toward regulation in the commercial finance industry must be monitored closely. The AFA was set up by the International Factoring Association for this very purpose. Other trade organizations that assist lenders also are on the watch for regulation, much of which is done at the local level. An elected state official in your district may not understand your business but has the power to regulate and change it. If you can, meet your elected local state legislator or a key staff member and let them know how factors and asset-based lenders help small businesses and entrepreneurs.

In addition, the trend toward increased regulation must be addressed in your document suite. Part two of this article will discuss how to best protect yourself in your agreements and related documentation. •