NATIONAL CREDITORS BAR ASSOCIATION

Experience Matters

Fintech & Online Lending

An Analysis of Online Loans, Defenses, and Counterclaims - Continued

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Overview

In our first Experience Matters recap, we addressed fintech, the challenges facing creditors rights attorneys, how fintech differs from traditional lending, and typical attacks on the model. Part II reemphasizes why understanding the transaction will be important in the coming years. This summary focuses on the merchant cash advance (MCA), a unique product related to online lending, that technically is not a loan.

Nicole Strickler and Luke Chamberlain of Messer Strickler Burnette sat with National Creditors Bar Association members to share the fundamentals of online lending and analyze common types of transactions and loans creditors rights attorneys need to understand when enforcing their clients' rights. What follows is Part II, a brief recap of the discussion related to fintech, online lending, defenses and counterclaims.

Understanding the Investor Scenario

Nationwide, there are efforts to increase the level of information provided to consumers. In 2009, for example, laws were completely different with nowhere near the level of documentation that is standard today. Pleading requirements were also not as onerous. California is a great example. Chain of title must be abundantly clear. State law requires that names of all persons who purchased debt be provided after charge off.

Why are we looking so closely at the investor scenario? Sometimes an attorney may be in a scenario where the sale back to the lender servicer from the investor doesn't occur until after charge-off. It's important to be clear about when these transactions are taking place. If not, attorneys can run afoul of these acts that ultimately can cause liability for clients, which in turn will cause indemnification claims back to the attorney. California may appear to be the strictest when it comes to enforcement, but efforts by other state courts are increasing the burden on those collecting debts.

The Merchant Cash Advance (MCA)

Many attorneys have not seen MCAs, but may run across in practices, particularly those who handle both consumer and business loans. The MCA is not a loan. It is a sale of assets. It doesn't involve a lender/borrower scenario. Instead, the MCA involves a buyer/seller relationship whereby the buyer is purchasing future receivables of a business in exchange for receiving funds for future receivables. In a MCA transaction the merchant remits future receivables back to the buyer by having the merchant's credit card processor send a specific amount of daily sales back to the merchant via ACH. This continues daily until the merchant has remitted a specified amount in full.

Loan vs Sale of Assets: A Critical Distinction

The MCA is not a loan, but a sale of assets. Most importantly, these types of arrangements are subject to state usury laws and whether these arrangements are subject to those laws. The MCA is not subject to those laws, allowing for an advantageous situation where parties entering into this kind of agreement have more discretion as per the terms. With conventional loans, that is not the case.

This unique product presents a scenario in which interest rate caps would not apply and are thus more beneficial from the lender's perspective.

Key characteristics of Merchant Cash Advance vs. Conventional Loan:

- **No unconditional or absolute agreement to repay the advances.**
- **No finite term for the remittance of the purchased receivables.**
- **No personal guarantee. May contain a guarantee of performance, but not of repayment.**
- **Reconciliation provision for estimated daily remittances.**
- **No recourse if the merchant files bankruptcy.**

These characteristics are important because in the event we don't understand the transaction we're subjecting ourselves to attack for usury. Several cases exist that deal with attacks where MCA was sought to be collected and defended by the obligor on the basis it was an illegal loan because it was usurious. Two such cases include:

> Cases [Pearl Capital Rivis Ventures LLC v. RDN Construction (54 Misc 3d 470 NY Sup Ct 2016); IBIS Capital Group LLC v. Four Paws Orlando LLC (2017 Supreme Court, Nassau County)]

Again, understanding the transaction is critically important, but something counsel may not run across particularly if not collecting business debt. Understanding the transaction is key to mounting defenses against counsel seeking to defend because they don't understand the transaction.

Loan vs Sale of Assets: A Critical Distinction (continued)

Additional areas to consider with respect to MCA transactions are breaches and personal guarantees. There may be some guarantee that's not exactly personal. Some common things to look at that don't take the transaction out of the MCA category, such as breaches triggered by doing things contrary to the terms of the agreement are changing the credit card processor, accepting cash only, and changing designated bank accounts. These things can trigger personal liability because they are not based on straight repayment, but other factors that are considered important when looking at MCA scenario. All these scenarios prevent the obligor from repaying the loan.

A collections Issues "Checklist" should include:

- ☒ **Identifiable Breach** — Must be able to specifically identify the breach to pursue the balance.
- ☒ **Complaint Language** — Use proper terminology. (Buyer and Seller rather than Borrower and Lender)
- ☒ **Witness Preparation** — Witness must be able to properly describe product using proper terms.
- ☒ **Confessions of Judgement** — Witness must be able to properly describe product using proper terms. Proposal in New York to prohibit the use of COJ's in small business loans.

Issues in Fintech Funding

Looking back to the traditional bank partnership scenario explained in Part I, following are three issues to consider when approaching these scenarios:

Valid When Made – Arises when a national bank exports the interest rates from its home state where interest rate laws are favorable. Valid When Made doctrine stands for the proposition that the subsequent assignment of a validly made loan to a subsequent purchaser does not render the interest rate usurious.

True Lender – Situations where the true lender is being challenged by consumers making claims that the true lender under these circumstances is the loan servicer, not the bank funding the loan, and as such, the origination of the loan by the bank should be disregarded, i.e., "Rent-a-charter" program.

OCC vs. FDIC – Regulations by the Office of the Comptroller of the Currency and the FDIC.

All this to say, analyzing these issues prior to suit is advisable.