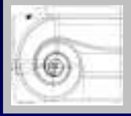

DREHER TOMKIES LLP

ALERT

FOR CLIENTS AND FRIENDS OF DREHER TOMKIES LLP

May 3, 2023

CFPB DECLARES MERCHANT CASH ADVANCES "CREDIT" UNDER NEW SMALL BUSINESS DATA COLLECTION RULE

Turning away industry commentators, the Consumer Financial Protection Bureau ("CFPB") has declared merchant cash advances "credit" for purposes of small business data collection under the Equal Credit Opportunity Act, 15 U.S.C. §§ 1691 *et seq.* ("ECOA"), with potentially important further compliance implications for merchant cash advance providers, many of whom take the position that their merchant cash advances are true "sales" of future accounts receivable, not "credit" per se. *See* Small Business Lending Data Collection under the Equal Credit Opportunity Act (Regulation B) (consumerfinance.gov) (effective 90 days after date of publication in the Federal Register, with compliance dates for select institutions as early as October 1, 2024); *see* our Alert of Mar. 28, 2023.

Under the new Small Business Data Collection Rule ("Rule"), "covered financial institutions" (broadly defined to include non-depository providers of financing services) are required to collect and report data regarding "covered applications" (an oral or written request for a covered credit transaction in accordance with applicable procedures) from small businesses for certain covered credit transactions. 12 C.F.R. §§ 1002.103, 1002.105. A "covered credit transaction" is one that meets the definition of business credit under existing Regulation B, with certain exceptions, and expressly includes loans, lines of credit, credit cards, *merchant cash advances*, and credit products used for agricultural purposes, but expressly excludes trade credit, public utilities credit, securities credit and incidental credit. *Id.* § 1002.104 (emphasis added). "Factoring" is distinguished as "an accounts receivable purchase transaction between businesses that includes an agreement to purchase, transfer, or sell a [current] legally enforceable claim for payment for goods that the recipient has supplied or services that the recipient has rendered but for which payment in full has not yet been made". 12 C.F.R. Part 1002, Supp. I, Official Interpretation 1002.104(b)—1. A financial institution is to report an extension of business credit incident to a factoring arrangement that is otherwise a covered credit transaction as "Other sales-based financing transaction" under Section 1002.107(a)(5) of the Rule. The CFPB did not specifically define "sales-based financing" in the Rule because the CFPB believes such products are covered by the definition of "credit" in final Section 1002.102(i), although it noted comparative definitions under California and New York commercial disclosure laws.

Merchant cash advances are typically structured as sales of *future* receivables that do not create an absolute obligation to repay, a characteristic that generally distinguishes such advances from loans subject to usury limitations and potential state licensing. The CFPB believes that the statutory term "credit" in ECOA is intentionally broad, including a wide variety of products without specifically identifying any particular product by name such that it can encompass all financing products not expressly excluded. In the CFPB's view ECOA's definition of "credit" makes dispositive the fact that one party has granted another the right to repay at some time subsequent to the initial transaction, without consideration of factors such as the absence of recourse or analysis of who bears the risk of loss.

Considering merchant cash advances as "credit" for data collection purposes has potentially important further implications for compliance with ECOA's anti-discrimination and adverse action notice provisions. Reviewing the marketplace shift from traditional providers of business credit like banks to non-traditional credit providers, the CPFB specifically noted that non-traditional credit providers are more likely to use complex algorithms and artificial intelligence, which may create or heighten "risks of unlawful discrimination, unfair, deceptive, or abusive acts or practices . . . or privacy concerns." *See* our Alert of Apr. 28, 2023 (increased regulatory focus on automation in financial services). The CFPB believes that the higher frequency of merchant cash advance use among minority-owned businesses coupled with reports of problematic provider practices lends credence to claims that merchant cash advances may raise fair lending concerns, arguably justifying the inclusion of merchant cash advances in the Rule in the absence of broader regulation by states. Whether the CFPB's view will be adopted more broadly is uncertain, although the California and New York attorneys general submitted comments in support of the inclusion of merchant cash advances. Some states, such as California, New York, Virginia and Utah, have begun regulating merchant cash advances through the inclusion of such products in their commercial financing disclosures; however, regulation beyond such disclosure requirements remains limited. *See* our Alerts of May 6, 2022, June 15, 2022, Feb. 10, 2023 and Feb. 28, 2023.

One difficulty with regulating commercial financing transactions

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is the great variety of product terms and features. The CFPB focused on particular products that it termed “typical”. Merchant cash advance providers should carefully review their policies and procedures in light of this regulatory development to determine is changes are appropriate. Let us know if you need assistance with your compliance or would like additional information. ❑

✧ *Mike Tomkies and Mercedes Ramsey*