



Merchant cash advances

What are the legal issues?

By Robert Cook and Joseph Looney

One of the hot products ISOs can offer to merchants that accept credit cards is the merchant cash advance. While the cash advance product has been around for many years, it has not been a product embraced by ISOs and others in the credit card processing space.

However, that is changing. It is quickly becoming a standard product offering of ISOs and others. The growth of the product is due both to the benefits it offers the merchant and the increased revenue opportunities it offers ISOs. ISOs use merchant advances as a selling point to convince a merchant to switch processors. However, when an ISO is considering offering a cash advance product, there are several legal issues the ISO should consider. This article provides a general overview of these legal issues.

Loan vs. Sale

Some cash advance providers intentionally structure the product as a loan while others structure it as a sale. For companies that structure the product as a sale, any person that partners with the cash advance provider should verify the cash advance provider actually treats the product, in all respects, as a sale.

Financial assets are sold every day. Examples include mortgages, automobile contracts, accounts receivable, etc. The price at which these assets are sold is based on what a buyer is willing to pay for the asset. The cash advance product is similar in that the merchant's credit card transactions are converted into payment rights through the credit card processing system, creating an obligation on acquiring banks and their agents to forward the funds associated with the credit

card transactions to the merchant. This right to funds is a financial asset that a merchant may sell. Therefore, if properly treated and documented, there is no reason why a cash advance cannot be treated like any other purchase and sale transaction.

Whether a cash advance is a loan or a sale depends on the intentions of the parties. The fact that the signed agreement says the transaction is a sale is irrelevant in most states. In order to be a purchase and sale transaction, the cash advance provider must assume some risk other than the typical risk in a loan transaction (risk of non-payment) and must treat the transaction as a sale. Many cash advance providers assume the risk that the business will slow down or possibly close. These are risks not present in a loan transaction, which generally includes a set repayment schedule. Additionally, many cash advance programs do not

od, and has no minimum payment, how the cash advance provider actually treats the transaction will be the deciding factor.

An ISO should be concerned about whether or not the cash advance provider treats the transaction as a sale as it impacts the laws that may apply to the ISO. For example, if the transaction is deemed to be a loan, the ISO may need to be licensed as a loan broker. Additionally, the commission the ISO receives may be regulated by various state laws if the transaction is a loan.

Usury

A typical cash advance transaction involves the purchase of a merchant's future credit card transactions at a discount. For example, a cash advance provider may purchase \$13,000 of credit card transactions for \$10,000.

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include a payback period, have no minimum payments, and charge no fees. These are all facts that support the conclusion that the transaction is a sale and not a loan. However, whether or not a cash advance is a loan is an issue that is determined by the intent and actions of the parties. Therefore, even if the agreement with the merchant states that the transaction is a sale, has no repayment peri-

Some argue that the discount paid for the credit card transactions amounts to a usurious effective interest rate. However, applying the law of usury to a true sale is difficult for two reasons.

First, usury is a legal term to refer to a rate of interest that exceeds the maximum rate permitted under applicable state law. If there is no maximum legal rate, there can be no usury. Many states do not impose a maxi-

imum interest rate for business-to-business transactions. In these states, even if cash advance transactions are characterized as loans, there is no risk of a usury violation.

Second, in the states with a usury limit on business-to-business transactions, it is impossible to determine at the time of consummation whether a cash advance contract with no set repayment term is usurious.

The only way to make such a determination is to wait until the transaction is complete and see how long it took for the cash advance provider to collect the funds it purchased. Only then can you divide the dollar amount associated with the discount by the repayment term to calculate an "effective rate of interest."

If an ISO is concerned that a transaction may be treated as a loan, then it should understand the usury risk. In many states, the law requires any interest charges above the maximum rate be returned to the borrower. In other states, the law requires all interest charges in a usurious loan to be returned to the borrower and some states make the entire transaction unenforceable.

A handful of states also include a criminal usury cap (e.g. New York). Any person that charges interest greater than the criminal usury cap is subject to penalties under the criminal law. One way to manage this risk is for the cash advance provider to include a choice of law provision in its merchant agreements that selects the law of a state with no usury law. Such a clause should be enforceable in a commercial contract if the state selected has a reasonable relationship with the transaction (e.g. state where borrower resides or where lender is located).

Collection Issues

Another significant issue associated with the cash advance product is the collection practices of the cash advance providers. The collection practices can be very intense and in some cases may violate state laws.

Examples of collection practices that may violate state law are making collection calls repeatedly in an attempt to harass the merchant, calling merchants at hours that are unreasonable, making false statements when collecting (telling the owner of the business merchant he/she will go to jail for failure to pay). While almost all states regulate consumer collection activities, many also regulate commercial collection activities.

The collection practices of cash advance providers are also relevant to the loan versus sale issue. If a cash advance provider collects on an account as if it were a loan (requires catch-up payments when the merchant's business slows down or requires repayment in full after a set period of time regardless of the merchant's credit card processing volume), the transaction looks like a loan. Thus, collection practices become relevant in determining the intent of the parties and may result in a transaction being characterized as a loan.

The collection practices of cash advance providers are relevant for ISOs in another way as well. Aggressive collection practices by a cash advance provider may irritate merchants and provoke them to change processors.

Unfair Trade Practices

Many states as well as the federal government have statutes or regulations that prohibit unfair and deceptive acts or practices (commonly referred to as "UDAP" laws). The UDAP laws are usually written broadly and permit the appropriate regulator or attorney general to bring an action against a company regardless of whether consumers or businesses are harmed.

This is evident by recent UDAP actions brought by various state regulators and the Federal Trade Commission against companies that are engaged in leasing credit card terminals to small businesses. Companies that partner with cash advance providers should

understand how the providers market and collect the product. Practices such as marketing a product with a discount rate for which no merchants qualify (bait and switch), misleading the merchant as to the true nature of the transaction, or harassing a merchant that breaches the cash advance agreement are all practices that are clear UDAP violations.

Other Issues

Cash advance transactions are business-to-business activities. Therefore, many of the laws that apply to business to consumer transactions do not apply. However, there are still many laws that do apply (e.g. Fair Credit Reporting Act, USA Patriot Act, Uniform Commercial Code, OFAC, etc.). All of these laws impose responsibilities on cash advance providers.

Before an ISO partners with a cash advance provider, the ISO should perform sufficient due diligence on the cash advance provider to verify the cash advance provider is aware of the legal risks associated with the product and has sufficient procedures and policies in place to manage the risks. **TT**

Robert Cook is a founding partner of Hudson Cook, LLP. He works with nationwide lenders and investment institutions that serve the consumer and small business market sector. He has served on the Federal Reserve Board Consumer Advisory Council and is active in the American Bar Association Subcommittee on Consumer Financial Services.

Joseph Looney is general counsel of RapidAdvance, LLC, a cash advance provider. Prior to joining RapidAdvance, Mr. Looney was a partner at Hudson Cook, LLP where his practice focused on compliance issues for credit card issuers, financial institutions and debt collectors. If you would like additional information or citations for any of the legal references in this article, contact Mr. Looney at jlooney@rapidadvance.com.