DEVELOPMENTS IN REVENUE BASED FINANCING

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INTRODUCTION

On 22 September 2022, we published *Growing Trend of Revenue Based Financing and its Legal Implications*, which described revenue-based financing (RBF) and its growing popularity for use as an alternative financing option, as well as increasing regulation and private litigation. This alert provides an update on the legal and regulatory landscape applicable to RBF. We recommend reading our prior alert in conjunction with this one.

GROWING REGULATION

As evidenced by the summaries below, the regulatory landscape applicable to RBF is rapidly evolving and parties active in this space should closely monitor developments.

As of September 2022, there were four states expressly regulating RBF. There are now seven additional states with bills working through the legislative process. The pending legislation share similarities including mandated disclosures, delegated enforcement to state agencies, penalties/remedies, and exemptions.

In Maryland, the Senate passed Bill 496, which has gone to the House for a vote. The proposed legislation would require providers of sales-based financings of US$2,500,000 or less to disclose consumer-like loan information in RBF transactions.

In Connecticut, the Banking Committee of the Senate passed Bill 1032 in early March, to regulate “sales-based financing” and certain other types of credit, including “merchant cash advances.” Bill 1032 would require the disclosure of an estimated annual percentage rate (APR), which the Senate deemed “critical” for small business borrowers to be able to make fair comparisons among financing products. The proposed legislation also includes fines up to US$10,000 for violations.

Florida is also considering RBF legislation through the Florida Commercial Financing Disclosure Law (Senate Bill 1624 and House Bill 1353) (CFDL). The CFDL would require disclosure of the transaction terms including total amount of commercial financing; the total cost of the financing; the manner, frequency, and amount of each payment; and certain other information related to prepayment rights and penalties. Notably, however, the CFDL stops short of requiring an APR disclosure.

The Kansas Senate (Bill 245) and Missouri (Senate Bill 187 and House Bill 584) are also considering new RBF legislation with similar disclosure obligations including APR.

On 5 April 2023, Georgia passed amendments to the Fair Business Practices Act which await Governor Brian Kemp's signature. The Fair Business Practices Act would regulate accounts receivable transactions with

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mandatory disclosures, but exempts providers that conduct no more than five commercial financing transactions within a 12-month period, as well as transactions of more than US$500,000.

In February 2023, Illinois introduced the Small Business Truth in Lending Act, which expressly governs RBF transactions. This proposed legislation would create civil penalties and government enforcement mechanisms for violations as well as individual rights of action for damages, attorney's fees and costs against providers of commercial financing (including RBF). Violations of the Small Business Truth in Lending Act would also amount to per se violations of the Illinois Consumer Fraud and Deceptive Practices Act. The Small Business Truth in Lending Act would require the disclosure of the terms of RBF transactions of less than US$250,000 including the total amount, APR, total repayment, and term.

LITIGATION DEVELOPMENTS

Most reported RBF litigation continues to take place in the Southern District of New York (SDNY) with claims that RBF transactions are really loans that violate state usury law and the collection of which violates the civil Racketeer Influenced Corrupt Organizations Act (RICO). Three factors continue to drive the distinction between an RBF and a loan. First, actual reconciliation of repayments to revenue is indicative of a revenue sale as opposed to regular periodic repayments that evidence a loan. Second, an indefinite repayment term is indicative of a revenue sale while a finite term to maturity points toward a loan. The third factor is the risk of non-payment. If the financer bears the risk of the company failing and does not have recourse then the transaction looks more like a RBF.

Against this legal backdrop, New York federal courts have been reluctant to grant motions to dismiss or dispositive motions at the summary judgment stage allowing claims to proceed to discovery and, in some instances, trial. In September 2022, the SDNY denied a merchant cash advance (MCA) company's motion to dismiss in *New Y-Capp v. Arch Cap. Funding, LLC*,[1] finding that the plaintiff sufficiently pleaded that their RBF transaction was really a usurious loan the collection of which violated RICO. This ruling by the court was based on plaintiff's allegations that the MCA obstructed the borrower's use of the reconciliation provision, the agreement had fixed terms and repayment obligations, and the borrower continued to be absolutely liable for repayment in the event of a bankruptcy.

The Eastern District of New York followed course in *AKF, Inc. v. W. Foot & Ankle Ctr.*,[2] where it granted summary judgment on the company's usury defense. Faced with a breach of contract action by the MCA for failure to pay is agreed, the company asserted a usury defense. At summary judgment, the court ruled that the RBF was really a usurious loan. The court determined that the agreement's reconciliation was essentially useless, that because reconciliation was useless the agreement effectively had a 205 fixed term, and because the MCA could recover in bankruptcy, it really did not bear the risk of loss.[3]

These cases further illustrate that the distinction between RBFs and loans are more than mere labels—the terms of the transaction matter. RBF providers should ensure that their transactions have real reconciliations, indefinite terms, and shift risk of non-payment.

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CONCLUSIONS

There has been rapid growth in RBF both from an investor prospective as well as for recipients of this funding because it provides a new class of funding that is non-dilutive from an equity ownership perspective but allows companies that would otherwise not qualify for traditional bank financing to gain access to important growth capital. As RBF becomes more popular and more states enact legislation, those involved in RBF should closely monitor developments to ensure compliance. Aggrieved and opportunistic customers will continue to test the bounds of usury law as well as new and pending legislation.

FOOTNOTES

[1] *New Y-Capp v. Arch Cap. Funding, LLC*, No. 18-CV-3223 (ALC), 2022 WL 4813962 (S.D.N.Y. Sept. 30, 2022)

[2] *AKF, Inc. v. W. Foot & Ankle Ctr.*, No. 19CV7118PKCST, 2022 WL 4538869 (E.D.N.Y. Sept. 28, 2022)

[3] *Id.* at *7-8.

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