ANGEL CAPITAL ASSOCIATION

TRENDS TO WATCH
State Regulation of Merchant Cash Advance Lenders
Threatens to Regulate Angel Investments
June 2022

<u>What does state regulation of merchant cash advance lenders have to do with being an angel investor?</u>

States are amending their commercial finance disclosure laws to tighten the regulation of merchant cash advance lenders. But the rules cover revenue lenders as well, and, in some instances, rules are even being proposed and considered to regulate old-fashioned small business loans like convertible notes.

These laws, called Commercial Finance Disclosure Laws ("***CFDLs***"), are modeled after consumer financing disclosures in the federal Truth-in-Lending Act (TILA), despite significant differences between consumer and commercial financing. They generally regulate the following categories of loans: (i) sales-based financing (covering merchant cash advance and revenue loans); (ii) asset-backed loans; (iii) factoring loans; (iv) closed-end commercial financing, and (v) open-end commercial financing.[1]

For now, a traditional and typical convertible note of the type typically used by angel investors without any revenue loan provisions would not trigger any of these state regulations.

Most states will require certain types of lenders to furnish state-specific disclosures before consummating sales-based financing transactions under their respective commercial finance disclosure laws.

However, some of the state laws we discuss below have broader definitions of what type of investments trigger mandatory disclosures and potentially lender registration. In addition, several states are revising their commercial finance disclosure laws to have even broader applications than revenue lenders to include all lenders of any type of commercial loan.

Generally, these new laws target smaller transactions like merchant cash advances and exempt larger transactions. For example, New York exempts transactions larger than $2.5 million, while California and Virginia exempt transactions larger than $500,000.

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[1] New York, California, Connecticut, Maryland, New Jersey, North Carolina:

In these states, "Commercial financing" means "open-end financing, closed-end financing, sales-based financing, factoring transaction, or any other form of financing, the proceeds of which the recipient does not intend to us primarily for personal, family, or household purposes."

Overview of Legislative Trend

States such as New York (Senate Bill 5470; “Disclosure Law” (2022)), California (Senate Bill 1235; “Commercial Financing Disclosures” Law (2021)), and Virginia (“Sales-Based Financing Providers” Law) as well as Connecticut (2021 Senate Bill 745), Maryland (2022 Committee Bill 825[2]), Mississippi (2022 Senate Bill 2629[3]; 2022 House Bill 1178[4]), Missouri (2022 Senate Bill 963), New Jersey (2022 Senate Bill 819), North Carolina (2021 House Bill 969), Pennsylvania (2021 House Bill 1793), and Utah (Senate Bill 183) have various legislative or regulatory developments underway.

States generally define “providers” as a person (which would include an individual angel investor) that extends a specific offer of commercial financing to a recipient or a broker to present specific offers in place of the provider.[5] Meaning, if you are a *commercial financing provider* in one of these states, you may have to make certain disclosures, register as a lender, and qualify to do business in those states.

Some states (Mississippi, Missouri, and Utah) do not adopt the term “sales-based financing” and instead broadly require disclosures from all commercial financing providers defined as those making “any commercial loan” or “business purpose transaction,” regardless of whether the loan is secured.

The enactment of CFDLs will potentially subject lenders to three different state requirements: disclosures, licensing, and registration. As of this moment, most of the pending regulations require only disclosures, but later rulemaking may add licensing or registration obligations to the disclosure requirements (see Virginia and Utah’s CFDL, which includes registration requirements; see also New York’s Senate Bill 1061 to add licensing conditions).
Because CFDLs vary significantly among the states, lenders may have to comply with multiple separate processes or adjust their practices to fall within the variant state exemptions.

Generally, these laws exempt persons who do fewer than five or few transactions a year. Many of these laws also exempt commercial financing secured by real property. Also, in general, for the moment, these laws do not pick up the traditional angel investor convertible note unless it has revenue loan type features.

It is also fair to point out that all these laws would not apply if an investment were made pursuant to Y combinator’s safe document, which is expressly not a debt instrument and constitutes equity in a company.

Virginia

Applicability:

[2] Failed. Died in committee.

[3] Failed. Died in committee.

[4] Failed. Died in committee.

[5] New York CFDL’s § 801(h) definition of “provider” tracks the definition of provider in most states

Virginia's commercial finance disclosure law (CFDL), effective July 1, 2022, will require sales-based financing providers and brokers to register with the commissioner of financial institutions by November 1, 2022.

Virginia was the first state to legislatively adopt a *sales-based* financing law, which defined "[s]ales-based financing" to mean:

> ". . . a transaction that is repaid by a recipient to the provider, over time, as a percentage of sales or revenue, in which the payment amount may increase or decrease according to the volume of sales made or revenue received by a recipient. Sales-based financing also includes a true-up mechanism where the financing is repaid as a fixed payment but provides for a reconciliation process that adjusts the payment to an amount that is a percentage of sales or revenue."[6]

The above language is meant to cover merchant cash advance lenders and covers revenue lenders.

Virginia's CFDL defines a "provider" as a person that extends a specific offer of *sales-based financing* directly to a recipient or through a third-party broker who, for compensation or in the expectation of compensation, obtains or offers to obtain sales-based financing from a provider for a recipient.[7]

Angel investors may be considered "providers" if they make revenue loans or other sales-based financings to a borrower in Virginia. A typical convertible promissory note is unlikely to be considered sales-based financing for purposes of Virginia's law. But revenue loans would be regarded as sales-based financing.

Exemptions from Virginia Law:

The provisions of Virginia's CFDL will not apply to nor place any additional requirements or obligations upon any of the following:

1. A financial institution;

2. Any person, provider, or broker that enters into no more than five sales-based financing transactions with a recipient in a 12-month period; or

3. A single sales-based financing transaction in an amount over $500,000.

(2022 Virginia Laws Ch. 516 (H.B. 1027) to amend the Code of Virginia by adding *§ 6.2-2228)*.

Disclosures Required Under Virginia Law:

Each provider has to provide the following disclosures to a recipient at the time of extending a specific offer of sales-based financing, according to formatting prescribed by the state:

1. The total amount of the sales-based financing, and the disbursement amount, if different from the financing amount, after any fees deducted or withheld at disbursement.

2. The finance charge.

3. The total repayment amount, which is the disbursement amount plus the finance charge.

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[6] Code of Virginia § 6.2-2228. Definition of "Sales-based financing"

[7] Code of Virginia § 6.2-2228. Definition of "Sales-based financing provider" or "provider"

4. The estimated number of payments, which is the number of payments expected, based on the projected sales volume, to equal the total repayment amount.

5. The payment amounts, based on the projected sales volume (i) for payment amounts that are fixed, the payment amounts, frequency, and method or (ii) for payment amounts that are variable, a payment schedule or a description of the method used to calculate the amounts and frequency of payments and payment method.

6. A description of all other potential fees and charges not included in the finance charge, including draw fees, late payment fees, returned payment fees, and prepayment fees or penalties.

7. If the recipient elects to pay off or refinance the sales-based financing prior to full repayment, an updated disclosure of:

a. The information required by subdivisions 1 through 6 as of the day of prepayment or refinance; and

b. A description of prepayment policies, including whether the recipient will be required to pay any additional fees, penalties, or other amounts not already included in the finance charge, or if the recipient will receive any discount to the finance charge.

8. A description of collateral requirements or security interests, if any.

9. A statement of whether the provider will pay compensation directly to a broker in connection with the specific offer of sales-based financing and the amount of compensation.

(2022 Virginia Laws Ch. 516 (H.B. 1027) to amend the Code of Virginia by adding *§ 6.2-2228)*.

New York

Applicability:
New York's "Consumer Financing" disclosure law (NY CLS Fin Serv §§ 801-812) requires disclosures from both lenders and brokers and applies to *commercial financing transactions*, which means closed-end financing, open-end financing, sales-based financing, and factoring transactions of $2.5 million or less. Although the law technically went into effect on January 1, 2022, compliance obligations will not arise until state regulators issue "final implementing regulations and those regulations take effect."[8]
In general, New York's CFDL does not pick up the traditional angel investor investing via a traditional and typical convertible note unless it has revenue loan provisions.

Exemptions From New York Law:

The NY CFDL exempts a "financial institution," which includes federally and state-chartered banks, savings and loan associations, savings banks, credit unions, trust companies, and industrial loan companies authorized to conduct business in New York. In addition, the law does not apply to transactions secured by real property, leases as defined in UCC Section 2-A-103, financings to car dealers or rental vehicle companies, or lenders regulated by the federal Farm Credit Act.

Like Virginia and California, NY's CFDL does not apply to "[a]ny person who makes no more than five commercial transactions in [New York] in a twelve-month period."[9]

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[8] New York Department of Financial Services Letter

[9] § 802(f). Exemptions.

Disclosures Required Under New York Law:

NY's CFDL will require providers to provide specified disclosures before consummating specific offers for the financing transactions to be signed by the recipients.

Currently, NY's CFDL does not have a licensing requirement. However, pending legislation (S1061 and A1420) would require a license from those generally engaged in commercial financing products in New York of $500,000 or less, which include equipment leasing transactions and secured and unsecured loans.

California

California has published a series of proposed regulations to implement its "Commercial Financing Disclosures" law (CA Fin Code §§ 22800-22805), which requires disclosures from certain commercial financing providers, including small business loans and merchant cash advances. SB 1235 was signed into law on September 18, 2018, but compliance with the new disclosure requirements is not until the California Department of Financial Protection (DFPI) promulgates final regulations.

Angel investors may be considered "providers" if they make revenue loans or other sales-based financings to a recipient in California. A typical convertible promissory note is unlikely to be considered sales-based financing for purposes of California's law.

Applicability:

The California CFDL requires providers of *commercial financing* (defined as "accounts receivable purchase transaction"[10]) to provide disclosures for transactions that are $500,000 or less and applies to factoring, asset-based loans, open-end credit plans, and leases that are not intended for personal, family, or household purposes. "Accounts receivable purchase transaction" means a transaction as part of an agreement requiring a recipient to forward or otherwise sell to the provider all or a portion of accounts, payment intangibles, or cash receipts that are owed to the recipient or are collected by the recipient during a specified period or in a specified amount.[11]

A "provider"[12] in California is defined as a person who extends a specific offer of commercial financing to a recipient and includes [the concept of a broker] a "nondepository institution," or non-bank partner, which facilitates a lender or originator's extension of financing to a recipient via an online lending platform. "Recipient" means a person presented with a financing offer by the provider equal to or less than $500,000.

Exemptions from California Law:

The California CFDL does not apply to financings greater than $500,000, financings secured by real estate, traditional financial institutions, lenders regulated by the Farm Credit Act, and financings to car dealers or vehicle rental companies (or affiliates of such dealers/companies). The California law also exempts persons making no more than one commercial financing transaction in California in a 12-month period or any person who makes five or fewer loans in a 12-month period that are "incidental to the business of the person relying upon the exemption."[13]

[10] 22800(d)(1) Definition of "Commercial Financing"

[11] 22800(b) Definition of "Accounts receivable purchase transaction"

[12] 22800 (m) Definition of "Provider"

[13] CA Fin Code Section 22801 (e)

An additional point to keep in mind is that it is yet unclear whether an entity that is exempt from licensure under the venture capital exemption to the California Finance Lender Law (CA Fin Code § 22062) has a basis for arguing it is likewise exempt from these new disclosure requirements. The specific scrutiny of so-called "sales-based" financing by regulators suggests that even if you are not required to obtain a license to engage with California companies, you will likely soon be required to provide disclosures unless you qualify for the above exemptions.

Disclosures Required Under California Law:

Providers will need to disclose to recipients specified information relating to the transaction at the time of extending the offer of commercial financing and obtain the recipient's signature on disclosure documents before consummating the loan.

Among other things, lenders will be required to disclose:

(1) The total amount of funds provided.
(2) The total dollar cost of the financing.
(3) The term or estimated term.
(4) The method, frequency, and amount of payments.
(5) A description of prepayment policies.

(CA Fin Code Section 22802 (2021)).

Significant modifications have been considered in a series of public comment periods to the proposed regulations issued by the DFPI, including definitions of key terms like "provider" and "specific commercial financing offer," disclosure requirements and thresholds, APR disclosure criteria, and more. The decreasing list of changes by the fourth of these modifications suggests that final rules are near, with compliance obligations expected to arise later this year.

Suggested regulatory approach

We propose that these rules and regulations expressly carve out sources of capital for companies that have not historically been a source of predatory lending or sharp practices. Ideally, angel investments via convertible notes would be expressly excluded from these rules altogether, given that they are not situations where borrowers are being charged insane interest rates or anything of that nature. The typical angel investor investing via a traditional convertible note should not be required any special disclosures or registrations. We would encourage state regulators to explicitly carve out individual angel investors who are making traditional convertible loans to start companies from these rules to avoid crimping the supply of capital to companies and harming job creation.

Takeaways

Although regulation of angel investors as lenders to early-stage startup and technology companies has been relatively light, investors, especially investors making revenue-based loans, should be watchful of these registrations and disclosure laws.

All these rules regulate lenders, so if you invest through a SAFE rather than a convertible note, you completely avoid all the risks associated with everything we've written in this article.

About the Angel Capital Association

Please keep us apprised of developments.

The Angel Capital Association is maintaining an active posture on proposed rules and regulations like the type discussed in this article. If you become aware of any new developments on this front, please do not hesitate to contact us and share the information, and we can then update this web page accordingly.

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