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Editorial Office
230 Park Ave., 7th Floor, New York, NY 10169 (800) 543-6862
www.lexisnexis.com

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The Growing Trend of Revenue-Based Financing and Its Legal Implications

By David E. Fialkow and Peter M. Ayers*

In this article, the authors explain that revenue-based financers should closely monitor state regulations, and ensure that their products maintain the characteristics of revenue-based financing. The authors add that, to avoid costly litigation and exposure, financers should take care that their products do not take on the characteristics of loans.

There is a growing need for alternative sources of capital for businesses that either cannot obtain, or do not want, traditional loans or private equity investments. Traditionally, there were essentially two financing options—debt, for which some entrepreneurs and some smaller business could not qualify, or the sale of equity, which results in decreased ownership. One expanding alternative is revenue-based financing (also known as sales-based financing and merchant cash advances), which takes on some characteristics of both. As with any growing financial industry, the legal framework is changing rapidly and the industry must be prepared.

WHAT IS REVENUE-BASED FINANCING?

Revenue-based financing is the extension of capital in exchange for a percentage of the business's future gross revenues. For example, a revenue-based financing provider provides US$100,000 to a business in exchange for 10% of the business's revenues until the business repays the provider a set amount, typically a multiple of the financed amount (if the multiple was 1.5x, in this example, the repayment amount would be US$150,000). Repayment is made periodically with direct draws from the business's account.

Because there is no fixed monthly payment (as revenues fluctuate), revenue-based financing does not have a set maturity date. If a business experiences high revenues, repayments will be larger and the repayment amount will be paid more quickly. Alternatively, if a business experiences lower revenues, repayments will be lower and the provider will be paid more slowly. If the business fails, the financer's repayment is at risk. Thus, revenue-based financing gives businesses more flexibility with repayment coinciding with actual revenues.

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* David E. Fialkow (david.fialkow@klgates.com), a partner in the Boston office of K&L Gates LLP, serves as a practice group coordinator for the firm's Financial Institutions and Services Litigation group. He regularly represents an array of financial institutions and service providers in disputes involving commercial and consumer finance products. Peter M. Ayers was an attorney at the firm.

There is little existing regulatory framework, but that landscape is changing.

CURRENT REGULATORY FRAMEWORK

Few states are currently governing revenue-based financing. Due to its growing popularity and the opportunity for unscrupulous actors, some states like Virginia, New York, Utah, and California have, or are attempting to, regulate revenue-based financing.

On April 11, 2022, Virginia signed HB1027[1] into law. HB1027 requires "sales-based financing providers" and "brokers" to register with the Virginia State Corporate Commission by November 15, 2022. It also requires the disclosure of certain revenue-based financing deal terms such as the amount financed, finance charge, repayment amount, estimated number of payments and amounts, fees, prepayment charges, collateral, and a host of other items. While HB1027 directs the Virginia State Corporate Commission to adopt implementing regulations, the statute is effective immediately.

On December 23, 2020, New York enacted the Commercial Finance Disclosure Law ("CFDL"),[2] which will also require the disclosure of similar repayment terms. Unlike Virginia's laws, however, the CFDL is not currently effective. While the CFDL technically became effective on January 1, 2022, the New York State Department of Financial Services is not requiring compliance until the implementing regulations are final.

On March 24, 2022, Utah enacted the Commercial Financing Registration and Disclosure Act ("CFRDA"),[3] which requires registration for businesses making "accounts receivable purchase transactions." Like Virginia and New York, the CFRDA requires mandatory disclosures including the "total dollar cost of commercial financing," but stops short of requiring the calculation and disclosure of an annual percentage rate. The CFRDA took effect on January 1, 2023.

Likewise, California enacted SB No. 1235,[4] which requires specific disclosures for revenue-based financers. SB No. 1235, and the California Department of Financial Protection and Innovation's implementing regulations,[5] which

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[1] https://lis.virginia.gov/cgi-bin/legp604.exe?221+ful+CHAP0516.

[2] https://www.nysenate.gov/legislation/bills/2019/s5470.

[3] https://le.utah.gov/~2022/bills/static/SB0183.html.

[4] https://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=201720180SB1235.

[5] https://dfpi.ca.gov/wp-content/uploads/sites/337/2022/06/PRO-01-18-Commercial-Financing-Disclosure-Regulation-Final-Text.pdf.

were scheduled to be effective on December 9, 2022 and will require revenue-based financing providers to disclose: the total amount of funds provided; the total dollar cost of financing; the term or estimated term; the method, frequency, and amount of payments; a description of prepayment policies; and the total cost of the financing expressed as an annualized rate.

While repayment terms and disclosures have commonly accepted and understood meanings in traditional loans, these definitions do not necessarily fit perfectly with revenue-based financing. Because revenue-based financing repayment is tied to actual revenue, there is no set repayment schedule and interest rates are not easily determined without estimates or assumptions. Revenue-based financers should closely monitor developing state laws to ensure compliance, and they should anticipate closer scrutiny.

INDIVIDUAL LITIGATION ENFORCEMENT

Revenue-based financers should also be aware of traditional methods of individual enforcement. Whenever there is an opportunity for profit, there is an opportunity for less scrupulous actors to exploit it. While revenue-based financing is for businesses, not consumers, many of the businesses seeking revenue-based financing are smaller and in need of capital, and could fall victim to aggressive financers. Predatory financing could lead to claims under state unfair and deceptive acts and practices ("UDAP") laws, usury laws, predatory lending, fraud, good faith and fair dealing, and federal Racketeer Influenced and Corrupt Organizations Act ("RICO").

In a recent string of cases in the U.S. District Court for the Southern District of New York ("SDNY"), businesses have alleged that their revenue-based financers violated RICO and state usury laws.[6] These plaintiffs alleged that their financings were not really revenue-based financing, but rather thinly veiled predatory loans with usurious rates and terms. Because they alleged the loans were usurious and illegal, their origination and collection were predicate acts for civil RICO claims. In each of these cases, liability hinged on whether the transactions were true sales of future revenues or disguised loans. If the transaction was a loan, the RICO and usury claims could proceed. If, however, the transaction was a true sale of future revenues, the claims would fail.

To answer this question, the SDNY has looked at three important factors to distinguish between a loan and a revenue sale.

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[6] *See Fleetwood Servs., LLC v. Ram Cap. Funding, LLC*, No. 20-cv-5120 (LJL) (S.D.N.Y. June 6, 2022); *Haymount Urgent Care PC, v. GoFund Advance, LLC*, No. 22-cv-1245 (JSR) (S.D.N.Y. June 27, 2022); *Lateral Recovery LLC v. Queen Funding, LLC*, No. 21 Civ. 9607 (CGS) (S.D.N.Y. July 20, 2022).

First, courts looked at reconciliation to determine whether the financing repayments were based on revenue actually received, or instead were just periodic at a set amount.

Second, the courts looked at whether there was a definite repayment term. If a financing transaction had a definite repayment term, it looked like a loan. If, on the other hand, it had an indefinite period of repayment, it looked more like a revenue sale.

Finally, and perhaps most importantly, the court looked at the risk of non-payment. If the financer bears the risk of the company failing and does not have recourse against the company or guarantors, then the transaction looks more like a revenue-based financing. If, however, the company has guaranties or requires confessions of judgment, then the transactions looked more like loans.

In each of these cases, the claims survived motions to dismiss, and in *Fleetwood Services*, the court granted plaintiff summary judgment on liability for its RICO claims.

To avoid potential liability under RICO and state usury laws, revenue-based financing providers should ensure that the structure of their financing transactions, taken as whole, resemble true sales of future revenues and are not just secured loans disguised as sales.

In addition, revenue-based financers should also be aware of state UDAP laws. State UDAP laws vary considerably in the scope of their coverage, the conduct and industries regulated, and potential exposure. Many state UDAP laws also provide for the possibility of class actions. Finally, traditional causes of action for breach of contract, fraud, and predatory lending are also potential claims.

IMPLICATIONS FOR REVENUE-BASED FINANCERS

The growing popularity of revenue-based financing, and the need for regulations like those in place in Virginia, New York, Utah, and California, make revenue-based financing an area of focus. The presence of bad actors could cast a negative light on an otherwise valuable and needed source of capital, and draw heightened scrutiny. Revenue-based financers should closely monitor state regulations, and ensure that their products maintain the characteristics of revenue-based financing. To avoid costly litigation and exposure, financers should take care that their products do not take on the characteristics of loans.