AMERICAN BAR ASSOCIATION
Business Law Section

CONSUMER FINANCIAL SERVICES COMMITTEE NEWSLETTER

January 2019

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Important Dates

Business Law Section Spring Meeting
March 28-30, 2019
Vancouver, BC

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Membership Minute

CFSC by the Numbers: As of October 2018, total members = 1,415. This represents a slight decrease since October 2017. Let's grow our membership by spreading the word about joining the CFSC! Encourage your clients and colleagues to check out the CFSC's fantastic programs, materials and networking opportunities!

CFSC Website: Did you know you can find links to helpful information on the website, including past newsletters, meeting materials and non-CLE Webinars? To learn more, visit CFSC website.

Get Involved in the CFSC: Want to get more involved in the CFSC? Feel free to contact Grace Powers, CFSC Membership Subcommittee Chair, Judy Mok and Shara Chang, Membership Subcommittee Co-Vice-Chairs, for information.

Leadership Message

I am really honored and excited to be assuming the chairmanship of this wonderful committee. We're nearly 1,500 members strong, which I'm told is a significant increase from 20 years ago when I first got involved. No doubt like many of you, I joined the committee at the invitation of a mentor. Gene Kelley and, later, John Ropiequet were instrumental in teaching and guiding me through the world of consumer finance. They encouraged me to write articles, attend meetings, prepare presentations and network with my peers. They said, "These are the people you will spend your professional life with—get to know them." Those were some wise and prescient words.

Many of my most enduring and collaborative professional (and personal) connections have been made on this committee. These friendships have inspired me not only to be a better attorney but also to be a better human being. I have observed civility, patience, kindness, generosity, curiosity, and humility. These experiences have taught me the value of seeking help, reflecting on mistakes, questioning intuition, listening to others, and forging new opportunities. Presence counts, but engagement is better.

You don't have to be a leader to have an impact. Be an influencer. In the next three years, I'd love to see even more engagement—not only by our regular attendees but by newcomers as well. Whether you're a young lawyer or a seasoned veteran, consider how you can get more involved in our activities and get others to do the same. In addition to our three annual meetings (which I promise include a lot of social events), we put on monthly webinars, publish newsletters and journals, organize pro bono outings, and produce a National Institute on CFS Basics. There's so much to do, and lots of room for others. Spread the word. If you're a partner at a law firm, get your associates involved. If you're a General Counsel, send your colleagues. As Adam Grant would say, you gain knowledge and skills through contribution: "One of the best ways to learn is to help others learn." If you haven't attended a meeting in a while, register for one this coming year. If you're not a regular attendee but would like to speak or write on a topic, reach out to a subcommittee—they'd love to hear from you. And if you're not sure about what to do, give me a call.

Anna-Katrina Christakis
Chair
Consumer Financial Services Committee

Meeting Announcement

The Consumer Financial Services Committee Meeting is scheduled for January 10-13, 2019 at the JW Marriott Miami Turnberry Resort & Spa.

We have a terrific meeting planned:

- Network at events including the Welcome Reception, Beer and Basics, and New Member Happy Hour.
- Choose from approximately 15 CLE sessions on the latest developments in Consumer Financial Services. The agenda is currently available.
- Participate in Consumer Financial Services Subcommittee and Task Force meetings.

Online registration has the meeting has closed, but attendees may still register onsite beginning at 4 p.m. on Thursday, January 10 at JW Marriott Miami Turnberry Resort & Spa.

Legal Feature

Small-Dollar Lending is Finally Evolving Into Something That Could Be a Win-Win for Consumers and Banks
By Nick Bourke

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By Michael DeFrank

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The new bank loan is notable because it is a straight-forward installment loan and is available to borrowers with severely damaged credit scores.[1] The bank typically uses checking account access to control losses, but safeguards ensure that payments take no more than 5% of the borrower's paycheck and cannot trigger overdraft fees. The loan largely meets the standards for safe small installment loans published at The Pew Charitable Trusts. And it was well-received by anti-payday loan stalwarts such as the St. Louis Post-Dispatch editorial board and others.

This loan comes with an Annual Percentage Rate of 71%, but most view this type of loan as fair and it would be hard to argue that it is not a major improvement for consumers over payday loans and other forms of subprime credit. The cost of borrowing $400 over three months is $48 with auto payments, which is admittedly $24 more than a hypothetical 36% APR loan as imagined

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[*] *Nick Bourke is director of consumer finance at The Pew Charitable Trusts, which is part of the nonprofit organization's family economic stability portfolio. His team has published dozens of reports and other materials on payday lending and the small-dollar loan market since 2011. He has worked with financial services and high tech companies as product manager, consultant, and legal adviser. Nick is a member of the State Bar of California. His email address is nbourke@pewtrusts.org.*

[1] The most serious flaw in U.S. Bank's Simple Loan product is that the finance charge consists of a single, up-front fee. This effectively penalizes anyone who pays the loan early, and it results in a fixed APR regardless of loan size (whereas APRs on installment loans ordinarily decline as loan size increases). All of the loans currently have a three-month repayment, so this flaw is not likely to affect a majority of loans; but if the loan program is ever expanded to allow larger loan sizes or longer repayment terms, the bank may need to change its policy about finance charges. Pew recommends spreading loan costs evenly over the life of the loan by charging interest plus a monthly maintenance fee.

under the Federal Deposit Insurance Corporation's ("FDIC") 2008-2010 pilot program. But it's also $312 cheaper than comparable credit from a typical payday lender (see **Table 1**), and potentially thousands of dollars cheaper than a similarly sized rent-to-own contract.[2] And again—critically—the structure of the loan is reasonable, with affordable monthly payments, safeguards that shield 95% of the borrower's paycheck, and other sensible protections. Polling shows that the majority of both the public and borrowers themselves find loans like this to be fair.[3]

Table 1: Simple Loan versus other options

Borrowing $400 for 3 months	
Typical payday loan ($15/$100)	$360
Typical auto title loan	$300
Paying 8 overdraft fees	$280
Typical pawn loan	$240
California payday loan	$408
Ohio payday loan (before reform)	$540
Ohio payday loan (new law)	$109
Deposit Advance ($10 per $100)	$240
New bank small-dollar loan	**$48**
Hypothetical 36% APR loan	$24

Conditions for this development have been ripening for several years. Consumer demand unfortunately remains steady as millions of families live paycheck-to-paycheck and experience persistent income volatility that punches $300 and $400-sized holes in household budgets. More than 10 million consumers continue to use payday loans each year.[4] At the same time, federal regulators have started to create a path that banks and credit unions can follow if they want to serve this demand responsibly.[5]

When the Consumer Financial Protection Bureau ("CFPB") finalized its payday loan rule a year ago, it cleared the way for depository institutions to compete in the small installment loan market by dramatically narrowing the scope of the rule compared to its original proposal. The final rule is tightly focused on short-term, balloon-payment loans while imposing virtually no requirements on amortizing loans that last longer than 45 days. While this left a lot of potentially

[2] Payday lending gets most of the attention in this space, but the reach of payday loans is not universal (payday loan stores exist in two-thirds of the states). Yet every state in the country has pawn and rent-to-own stores—and of course fee-based overdraft programs offered by banks and credit unions. With respect to fee-based overdraft, even though reasonable minds may disagree about some things, in a world where one-third of fee-based overdrafters view it as a way to borrow money and actively experience it that way—even though federal law essentially stipulates that it is not credit—we should all be able to agree that a safe small installment loan from a bank presents at least a partial resolution to this situation.
[3] Pew polling shows that 80% of the public view a $400, 3-month bank loan for $60 to be fair, as do 86% of payday loan borrowers. This loan costs $48 with auto payments.
[4] The Pew Charitable Trusts, "Payday Lending in America: Who Borrows, Where They Borrow, and Why" (2012), available at: https://www.pewtrusts.org/en/research-and-analysis/reports/2012/07/19/who-borrows-where-they-borrow-and-why. Given available market and regulatory data, Pew estimates that the number of payday loan customers has remained relatively unchanged at 12 million per year.
[5] Meanwhile, state legislatures have been gridlocked. Not a single state legislature has voted to eliminate a payday loan law, and legislatures have generally been ineffective at reforming payday lending—though Ohio is a notable exception.

harmful payday lending activity untouched by federal regulation,[6] as far as banks and credit unions are concerned it also eliminated a lot of regulatory uncertainty and risk.[7]

The prudential regulators meanwhile have been refining their approach to small-dollar lending. Shortly after the CFPB finalized its payday loan rule in 2017, the Office of the Comptroller of the Currency rescinded its guidance on deposit advance products ("DAP guidance"), based in part on the rationale that the CFPB's new rule will cover short-term loans like deposit advance products and the prior OCC guidance created risk of regulatory inconsistency. Then in May of this year, the OCC published a bulletin titled "Core Lending Principles for Short-Term, Small-Dollar Installment Lending." It states that the OCC "encourages banks to offer responsible short-term, small-dollar installment loans, typically two to 12 months in duration with equal amortizing payments, to help meet the credit needs of consumers." This is the essential part of the market for banks and credit unions to focus on, and it is the space where U.S. Bank's Simple Loan exists.[8]

The OCC's May 2018 bulletin provided a crucial mix of caution and encouragement to banks. It warned against overreach ("[p]roduct structures should support borrower affordability and successful repayment of principal and interest in a reasonable time frame"). But it also prompted banks to do more to serve customers on the margins ("[b]anks can provide affordable short-term, small-dollar installment lending options that can help consumers with their short-term financial needs while establishing a path to more mainstream financial products"). Bankers who enter this space will, rightly, face scrutiny from examiners when they look at small-loan programs that serve people with FICO scores of 600 or below with APRs that substantially exceed most subprime credit cards.[9] By suggesting ways to ensure the *quality* of small-dollar credit, the OCC has helped improve access to subprime liquidity loans that are actually beneficial to financially struggling consumers, and do not lead to abuse of their checking accounts or budgets. In other words, it has articulated a nuanced point of view that should help put the sometimes competing goals of "access to credit" and "consumer protection" into harmony.

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[6] Payday lending is increasingly an installment lending business model. Payday lenders now make installment loans in more than half the states.

[7] Reports of the CFPB payday loan rule's death have been greatly exaggerated. Though the agency has stated an intention to revisit the rule, as of this writing it had not published any details and knowledgeable sources report that the agency has made little headway in determining the legal or factual details that a new regulatory process would require. And while the agency has moved back the date for registering in the database required by the rule, it has not so far delayed the ultimate compliance date (August, 2019). More to the point: banks and credit unions that make small amortizing installment loans lasting longer than 45 days have virtually no compliance obligations under the rule as finalized, so they can largely ignore it anyway.

[8] Deposit advances are essentially payday loans offered by a bank at a slightly lower cost. They suffer many of the same flaws, especially balloon payments. It would not be accurate to describe Simple Loan as a deposit advance because it is an underwritten, amortizing installment loan and borrowers are not required to establish automatic payments from their checking accounts, among other reasons.

[9] Charge-offs and defaults may or may not appear high compared to mainstream loans. Some credit union and bank programs have experienced default rates below 6 percent, with just 2 to 4 percent of loans charging off. But some examiners will not be accustomed to the specialized nature of small-dollar liquidity lending and may be alarmed to see default rates that appear to be inappropriate due to annualizing the default rate on relatively short-term loans. For bank small installment loan portfolios that meet standards for affordable payments and other safeguards, Pew recommends additional scrutiny if 1 in 10 *loans* charges off. See Pew's issue brief for citations and additional information.

It is important to remember that, as of this writing, the FDIC's DAP guidance (which mirrored the OCC's guidance) remains in effect. If the agency chooses to defer to the CFPB's payday loan rule like the OCC did, it will likewise be important for the agency to clarify its expectations—and warnings—for the small installment loans that could replace them.[10] In November, the FDIC announced that it is seeking public comments about small-dollar lending and "what the FDIC can do to better enable banks to offer responsible, prudently underwritten credit products to meet consumer demand."

On the other side of the depository institution divide, the National Credit Union Administration ("NCUA") is considering changes to its Payday Alternative Loan ("PAL") program. Since 2010, the PAL program has allowed federal credit unions to charge more than the NCUA's generally applicable interest rate cap, as long as the loans meet certain consumer protection criteria. Yet the program has underperformed, with only 1 in 7 credit unions participating and originating fewer than 200,000 loans per year.[11] If the NCUA follows through with the right modifications to the program, credit unions could soon be making millions of affordable installment loans that cost 7 to 8 times less than payday loans, much like the new U.S. Bank loan.

While it is not possible to borrow one's way out of poverty, small installment loans can help millions of people with damaged credit scores who are living paycheck to paycheck—but only if the credit is structured the right way. Federal regulators have helped put that into focus by calling on depository institutions to create new types of amortizing small installment loans that meet strong but simple guidelines. One of the five largest banks in the country has already rolled out a new product that meets the call. Others may soon follow.

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[10] The OCC's rationale about deferring to the CFPB payday loan rule may become moot, given that the CFPB has announced its intention to revise the "ability to repay" provisions at the heart of its rule. At any rate, many organizations have called on the regulators to prevent the return of deposit advance. Pew's position has been that the DAP guidance should stay in place with a clarification that it applies only to loans with balloon payments or very short terms. The OCC could have taken this approach without hindering U.S. Bank's current efforts. The FDIC could still choose to take this approach. Regardless of what the CFPB does with its payday loan rule, prudential regulators have an interest in preventing short-term balloon payment loans from damaging the integrity of the depository system.

[11] With maximum charges of 28 percent annualized interest and a $20 application fee, effective APRs on PAL loans range from 35 to 148 percent depending on a loan's size and duration (disclosed Truth in Lending Act APRs may be lower because they do not include application fees). Credit unions that have participated in the PAL program deserve recognition for their efforts. The program's efficacy is reflected in a surprisingly low charge-off rate of just 2 percent, which is partially attributable to the fact that borrowers are already credit union members who make regular deposits to their checking accounts and typically repay via electronic debit. Yet the PAL program has tight revenue constraints, which is one reason that few of these loans are issued. The program will not scale unless it is modified; and to remain consumer friendly, the NCUA should move away from relying on frontloaded, non-Truth in Lending Act fees that artificially suppress the disclosed APR.

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Has the Switch Been Flipped on the TCPA's Definition of Autodialer?

By Michael DeFrank[*]

By any account, the 2015 FCC Declaratory Ruling and Order[1] took an expansive view of the statutory definition of ATDS in the Telephone Consumer Protection Act ("TCPA"). The 2015 Ruling interpreted the term "capacity" in the TCPA's definition of Automatic Telephone Dialing System ("ATDS") to include a device's "potential or latent functionalities" rather than being limited to what the equipment can do in its current configuration.[2] By most, but not all accounts, the March 16, 2018 decision of the D.C. Circuit in *ACA International v. FCC* narrowed the definition of ATDS by vacating the 2015 FCC Ruling and focusing on the ***current***, rather than potential, capabilities of a device in determining whether it qualifies as an ATDS.

This article examines some of the leadings cases in the post-*ACA International* world, including what may be a looming issue for the United States Supreme Court, following the Ninth Circuit's decision in *Marks v. Crunch San Diego LLC*.[3]

Switch-Flipping in the Circuit and District Courts Post-*ACA International*

The first circuit court to issue a decision which addressed the definition of autodialer in a post-*ACA International* world was the Third Circuit in *Dominguez v. Yahoo, Inc*.[4] In *Dominguez*, the Plaintiff purchased a cell phone with a reassigned number. The prior owner of the phone number at issue had subscribed to Yahoo's SMS service so that he would receive a text alert every time he received an email. Because the prior owner of the phone number did not inform Yahoo that his number had changed, the Plaintiff received a text on the reassigned number each time the prior owner received an email.

In 2014, the district court granted summary judgment to Yahoo because the Plaintiff had failed to show that Yahoo's SMS service had the present capacity to function as an autodialer. The

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LinkedIn: www.linkedin.com/in/mikedefrank

[1] *Rules & Regulations Implementing the Tel. Consumer Prot. Act of 1991*, 30 F.C.C.R. 7961 (2015).
[2] *ACA Int'l v. FCC*, 885 F.3d 687, 694 (2018).
[3] 2018 WL 4495553 (9th Cir. Sept. 20, 2018).
[4] 894 F.3d 116 (3d Cir. 2018).

Plaintiff appealed, and the Third Circuit remanded the case after the FCC issued its 2015 ruling. The Plaintiff amended its complaint to allege that Yahoo's system also had the potential capacity to function as an autodialer. The district court granted summary judgment for Yahoo on both the present and potential capacity issues. The *ACA International* decision was issued while the case was on appeal to the Third Circuit for the second time.

The Third Circuit held that *ACA International* meant that it must interpret the definition of an autodialer in the TCPA as it did before the 2015 FCC ruling. This meant that the argument that Yahoo's system was an autodialer because it had the potential capacity to function as an autodialer was no longer relevant. The Third Circuit then turned to the issue of whether Yahoo's system had the present capacity to function as an ATDS. The court held that only one of Plaintiff's four expert reports focused on present capacity, but nevertheless discounted the report because it was missing "any explanation of how [Yahoo's system] did or could generate random telephone numbers to dial."[5]

In *Dominguez*, the Third Circuit did discuss that, under *ACA International*, "present capacity" for purposes of being an autodialer could mean that some limited modifications to the device were necessary. The court cited the portion of *ACA International* that discussed how the capacity depends on the amount of effort required to enable the device to function as an autodialer: "[D]oes it require the flipping of a switch or does it essentially require a top to bottom reconstruction of the equipment?"[6] Although one of the experts' reports did propose a modification that was akin to "flipping a switch," the court excluded the report because it had a "striking similarity" to the downloading of an app, which was the same modification at issue in *ACA International* that was deemed to not qualify as an autodialer.[7] The Third Circuit proceeded to affirm the district court's grant of summary judgment in favor of Yahoo.

A mere three days later, the Second Circuit issued *King v. Time Warner Cable*[8], its first post-*ACA International* opinion addressing whether a device is an ATDS. In *King*, the Plaintiff alleged that Time Warner made 163 calls to her cellular telephone using an ATDS after she had revoked consent to be called. Relying on the 2015 FCC ruling, the district court had granted summary judgment for the Plaintiff. The district court held that Time Warner's system had capacity to act as an autodialer but did not discuss whether the system had present or potential capacity, as that distinction was unnecessary under the 2015 FCC ruling.

The *ACA International* opinion was issued by the D.C. Circuit while *King* was on appeal. Similar to the Third Circuit, the Second Circuit held that it no longer needed to follow the 2015 FCC ruling on account of *ACA International*. It then undertook its own independent analysis of whether the district court's broad definition of ATDS was proper. Finding little guidance in the plain meaning of "capacity" and the legislative history of the TCPA, the *King* court turned its attention to the reasoning in *ACA International*. The Second Circuit was particularly persuaded by the D.C. Circuit's distinction between a device that currently has the features that enable it to perform the function of an autodialer, and a device that can only perform those functions if

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[5] *Id*. at 120.
[6] *Id.* at note 23, citing *ACA Int'l v. FCC* at 696-698.
[7] *Id*.
[8] 894 F.3d 473 (2d Cir. 2018).

additional features are added. Like the Third Circuit only three days before it, the Second Circuit held that the TCPA's definition of ATDS is restricted to a device's current function, absent any modification to the device's hardware or software. The *King* opinion also stated that this definition includes devices whose autodialing features can be activated by the simple "flipping of a switch," but does not include every smartphone or computer that could be reprogrammed and turned into an autodialer.[9]

The Second Circuit held that that the analysis of present versus potential capacity may need to be conducted on a case–by-case basis. Indeed, the court vacated the district court's grant of summary judgment for the Plaintiff and remanded the case to the district court to determine whether Time Warner's autodialer had the ability to perform the functions of an ATDS.

In July 2018, the Northern District of Ohio in *Lord v. Kisling, Netisco & Redick, LLC*[10] dismissed a class action in which the Plaintiffs alleged that the Defendants had sent texts using a platform that had "the capability and/or functionality to launch bulk messages in seconds [and] . . . uses and requires a short code which is used for bulk and mass texting." The court noted that the Plaintiffs' complaint completely depended on the validity of the expansive 2015 FCC order, which encompassed present and potential capacity of a device to function as an autodialer. The *Lord* court elected to follow *ACA International* and rejected the "capability" or "potential functionality" test. In dismissing the Plaintiffs' complaint pursuant to Rule 12, the court held that a plaintiff may not simply parrot the statutory language of the TCPA and must allege facts "about the calls or circumstances surrounding the calls that make it plausible that they were made using an [ATDS]."[11]

The Ninth Circuit Flips the Script

Until September 20, 2018, it would have been safe to say that there was a trend after *ACA International* to limit the scope of the definition of ATDS or, at minimum, to require a case-by-case investigation as to whether a device has the present capacity to be an autodialer. However, the September 20 decision in *Marks v. Crunch San Diego, LLC* made it clear that there is no such trend in the Ninth Circuit.

In *Marks*, the Plaintiff filed suit alleging that the three text messages he received from the Defendant violated the TCPA because they were sent using an ATDS. The district court granted summary judgement to the Defendant, holding that the technology used to send the text messages did not meet the definition of an ATDS because it lacked a random or sequential number generator. The Ninth Circuit reversed but, instead of focusing on present or potential capacity, it vastly expanded the definition of ATDS to include, "a device that stores telephone numbers to be called, whether or not those numbers have been generated by a random or sequential number generator."[12]

In its opinion, the Ninth Circuit first found that the *ACA International* opinion invalidated not only the 2015 FCC ruling but also the FCC's 2003 and 2012 rulings with respect to predictive

[9] *Id*. at 481.
[10] 2018 WL 3391941 (N.D. Ohio July 12, 2018).
[11] *Id*. at *2.
[12] 2018 WL 4495553, at *1 (9th Cir. Sept. 20, 2018).

dialers. The court decided to "begin anew to consider the definition of ATDS under the TCPA."[13] The court held that the definition of ATDS in the TCPA was ambiguous and therefore looked to extrinsic sources in order to determine its meaning. The Ninth Circuit went on to hold that because Congress' intent in enacting the TCPA was "to regulate devices that made automatic calls," the statute's language captured equipment that made automatic calls from a list of recipients (as opposed to a random or sequential number generator)[14].

The *Marks* court also looked at the TCPA's exception for calls made with prior express consent and reasoned that in order to take advantage of this exception, a caller would need to "dial from a list of phone numbers who had consented to such calls, rather than merely dialing a block of random or sequential numbers."[15] The court similarly concluded that the 2015 amendment to the TCPA, which exempted use of ATDS for calls related to federal debts, demonstrated that "equipment that dials from a list of individuals who owe debt to the United States government is still an ATDS."[16] The Ninth Circuit remanded *Marks* to the district court in the Southern District of California to address the question of whether "capacity" in the definition of ATDS means present capacity or potential capacity to automatically call numbers from a list.

Conclusion

As many commentators have already observed, the divergent definitions of ATDS in the Ninth Circuit (*Marks*) and Third Circuit (*Dominguez*) may ultimately mean that the Supreme Court decides this issue. In the interim, we can expect arguments from plaintiffs' counsel that *Marks* has blown the doors open on the scope of what is an ATDS, while defense counsel will rely on those cases that followed the D.C. Circuit's more narrow definition in *ACA International*. If, on remand in *Marks*, the Southern District of California is persuaded by the cases which define capacity narrowly, it is still conceivable that that the device in that case could be outside the definition of ATDS.

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[13] *Id*. at *7.
[14] *Id*. at *8.
[15] *Id*.
[16] *Id*.

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Income Share Agreements (ISAs) for Education Financing: Understanding the Regulatory Treatment of a Rising "Loan Alternative"

By Eric T. Mitzenmacher and James K. Williams[*]

Outstanding student loan debt in the United States has steadily grown to become one of the largest categories of consumer debt, second only to residential mortgages. This growth has driven concern about a student loan "bubble," particularly in light of rising interest rates and job market volatility for new college graduates. Simultaneously, rising delinquency/default rates and the conduct of certain "bad actors" have led regulators to implement enhanced consumer protection regimes, including "student loan bills of rights" and new student loan servicing licensing requirements. These measures are intended to provide borrowers with fair and accessible pathways to loan repayment.

Against this background, educational institutions and some private entities have attempted to design financially viable student loan alternatives to meet the needs of students in an evolving economy. Income Share Agreements ("ISAs"), in which students are provided education financing in exchange for repayment of an agreed-upon percentage of income over a defined, post-graduation timeframe, are one of the most unique potential alternatives. ISAs' viability as a student loan alternative, however, may depend on whether traditional loan regulatory requirements apply to their unique structure. In particular, certain state licensing and usury laws may not necessarily leave room for the repayment flexibility inherent in ISAs. However, one option for developing a successful market in ISAs may be to ensure that ISAs are structured so they are not "loans" or other "credit" subject to certain consumer financial laws.

The issue of whether (or when) ISAs should be treated as loans or credit under federal or state consumer financial laws has not yet been resolved in the courts or addressed in detail by relevant regulators. ISAs are, however, similar to certain small business and commercial financing approaches such as merchant cash advances ("MCAs") and receivables factoring agreements under which businesses sell future or existing receivables in exchange for an up-front purchase price. To some extent, courts have opined on whether these approaches should be viewed as credit for usury, licensing, and other compliance purposes.

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Review of the treatment of MCAs and/or factoring agreements when subject to legal challenge arguably provides program structuring guidance relevant to ISA providers. In general, courts have reviewed whether a MCA or factoring agreement is a "loan" through fact-intensive, case-by-case evaluations. A key factor has been whether the initial amount extended under the agreement is an absolutely repayable obligation.[1] Where the financing party bears significant repayment risk (other than for a credit default), the product can be viewed as a true sale of receivables, rather than a loan. Courts also evaluate other indicia of a lending relationship, such that using personal credit history in underwriting, acquiring security interests, charging fees similar to typical loan fees, or representing the agreement as a loan may create risk of recharacterization as a loan.[2]

Recharacterization of ISAs could be assessed under standards similar to those that have been applied to MCAs or factoring agreements. Accordingly, structuring ISAs so that the provider has limited (or no) recourse in the event that earned salaries are lower than expected, underwriting to future employability rather than heavily toward current creditworthiness, structuring guarantees or co-signer relationships as backups to nonpayment of the contingent/salary-based repayment obligation rather than insufficient repayment of the initial extension of funds, and similar approaches would likely decrease the risk that the ISA will be treated as a loan subject to, for example, state licensing and/or usury requirements.

Since ISAs are consumer-purpose agreements (unlike MCAs and factoring agreements), the regulatory consequences of recharacterization are relatively high. In addition to the licensing and usury concerns already mentioned, compliance with several core federal consumer financial laws, including disclosure requirements under the Truth in Lending Act ("TILA") and interest rate restrictions under the Military Lending Act ("MLA") and Servicemembers Civil Relief Act ("SCRA"), would be ambiguous or difficult for ISA providers. Other requirements of federal and state law might only become formally applicable to ISAs if they were recharacterized as loans, but might be more suitable for voluntary compliance as a conservative approach to risk management. Such requirements might include, for example, anti-discrimination provisions of the Equal Credit Opportunity Act ("ECOA"), repayment restrictions under the Electronic Fund Transfer Act ("EFTA"), and consumer privacy and information security requirements under the Gramm-Leach-Bliley Act ("GLBA").

ISAs show potential as a student loan alternative. Their success in the market likely depends on providers "getting it right" in a tricky regulatory environment for products that do not cleanly slot into a well-defined and delineated asset class.

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[1] *See, e.g.*, *Transmedia Rest. Co., Inc. v. 33 E. 61st Street Rest. Corp.*, 710 N.Y.S.2d 756 (N.Y. Sup. Ct. 2000) (transaction is not a loan "unless the principal sum advanced is repayable absolutely."); *Essex Partners Ltd. v. Merch. Cash and Capital*, 2011 WL 13123326, at *5 (C.D. Cal. Aug. 1, 2011) (under California law, one of the "essential elements of usury" is "the loan and interest must be absolutely repayable by the borrower … ."); *Wiers Farm, Inc. v. Waverly Farms, Inc.*, 2011 WL 1296867, at *2 (M.D. Fla. Mar. 31, 2011) (re-characterizing transaction as secured loan because, in part, finance company did not agree to assume risk of nonpayment on all of purchased accounts).

[2] *See*, *e.g.*, *Math Magicians, Inc. v. Capital for Merch. LLC,* 2013 WL 6192559, at *3 (Cal. Ct. App. Nov. 26, 2013); *Wiers Farm, Inc.*, 2011 WL 1296867 at *2; *Nickey Gregory Co., LLC v. AgriCap, LLC*, 597 F.3d 591, 602-03 (4th Cir. 2009).