COVID-19 and MCA Transactions: Emergency Circumstances Demand Servicing Changes

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COVID-19 and the related emergency has had a dramatic effect on small businesses. States have implemented “stay-at-home” orders or otherwise ordered the closure of non-essential businesses, resulting in the virtual elimination of commerce. The health response to COVID-19 poses an existential threat to small business finance companies, and Merchant Cash Advance (“MCA”) companies in particular.

Under these unique circumstances, MCA companies face additional financial and legal risks. It is unlikely that an MCA contract specifically addresses a pandemic or any other emergency circumstance. However, under all MCA contracts, the merchant’s requirement to pay is contingent on the merchant earning receipts. MCA companies must honor that contingency to ensure that their contracts are not recharacterized as a loan. Given that commerce has ceased, it is unreasonable to expect that merchants are currently earning receipts, at least if they are non-essential businesses.

Under these emergency circumstances, MCA companies must take steps beyond normal reconciliation procedures to ensure that they are not requiring small businesses to make payments to which the MCA company is not entitled. If a business is closed due to the COVID-19 emergency, an MCA company is not entitled to any payments – even if the contract requires a business to wait 30 days and then request a reconciliation. MCA companies should not treat failure to make payments under these circumstances as an event of default under the MCA contract.

Failure to appropriately service MCA transactions is risky at this time, especially because the FTC is focused on the industry. The FTC recently released a Staff Perspective discussing its concerns in the MCA industry, including various failures to appropriately service the transactions.

Purchases of Future Receivables in Times of Emergency

The risks are not theoretical. At least one court has addressed MCA servicing issues in times of emergency, and MCA companies must apply those lessons now.

In 2016, Hurricane Matthew, a bruising Category 5 storm, bore down on the east coast of Florida and continued up the coast to Georgia, the Carolinas, and Virginia, causing death and destruction along the way. On October 5, 2016, Florida Governor Rick Scott declared a state of emergency throughout the state and mandated evacuations of certain areas, including Palm Beach County.

A Merchant in Palm Beach County had entered into an MCA transaction with an MCA company just two weeks before the storm. The business owner claimed that when he was forced to evacuate

(and close his business), he called a telephone number listed in his contract to advise the MCA company that he would close his business and thus not generate any receipts.

Nonetheless, the MCA company allegedly continued to withdraw daily ACH payments. The business subsequently lost all its perishable inventory as a result of the hurricane, and went out of business. The MCA company sought a judgment by confession for monies allegedly due under the contract. The court held that the transaction was a usurious loan. The MCA contract contained an appropriate reconciliation payment permitting adjustment of the payments, but the court discussed as follows:

"if [the MCA company] actually acknowledged a risk of loss in the context of [the MCA contract], then it would recognize that the hurricane event and declared emergency might present the type of circumstance which would affect its right and ability to collect anything from [Merchant]….its failure to contemplate let alone acknowledge, the possibility of not being repaid in this instance, the financial arrangement cannot be deemed anything short of a loan…."

The alleged failure of the MCA company to recognize the impact of unforeseen circumstances that prevented the Merchant from making payments on the contract resulted in the recharacterization of the transaction as a loan. All MCA companies should know that such a result results in the application of usury caps and, in some states, licensing requirements.

The evolving emergency circumstances stemming from COVID-19 present similar issues. MCA companies must ensure that they do not receive payments to which they are not entitled; they should suspend ACH payments from merchants that no longer receive revenue and appropriately reduce such payments for merchants experiencing reduced revenue, *even if the contract does not expressly provide for those steps.*

Additional Considerations for MCA Companies

MCA companies should also consider the following. First, many MCA contracts forbid a Merchant from entering into other loans or financing contracts. In the event federal or state governments extend loans to merchants as part of an economic stimulus package related to COVID-19, MCA companies should not consider entering into those loans as an event of default. Second, proceeds from government aid must not be considered revenue for purposes of calculating any reconciliations or payments, even if the language of a contract is arguably broad enough to cover those amounts. The intent of an MCA contract is to purchase receivables, not government benefits. In the current environment, engaging in sharp practices like these risk attracting regulator attention and could result in litigation claiming unfair practices by the MCA company.