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MEMORANDUM

TO:	Research File: Commercial Lending
FROM:	R. Paul Soter, Jr.
DATE:	March 24, 2022
RE:	Overview of Multistate Commercial Lending Rules in the United States

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This memorandum provides a general overview of the legal environment for nonbank multistate commercial lenders in the United States. It is not a comprehensive memorandum of the details of applicable law, or advice for any specific situation. Rather, it is a high-level summary of the legal and regulatory risk environment for commercial lenders. More detail on any particular aspect of this memorandum can be provided as needed.

Background

Multistate commercial lending was for largely dominated by banks many years. Over the past 20 years or so, however, nonbank lenders have increased their share of the U.S. commercial lending market significantly, while banks have generally become more conservative in their commercial lending policies. These are among the factors have led to a higher level of commercial lending activity generally.

Likewise, the role of specialty lenders has increased. These specialty lenders serve various niche markets, to a far greater degree than ever before. Those niche markets may be industry-specific, region-specific, or specific to business size. These specialty lenders have also, to some extent, increased the level of competition with traditional non-credit financing such as factoring, and have largely been responsible for the development of so-called merchant cash advance financing for businesses with small balance sheets and high transaction volume.

Finally, of course, is the fact that the U.S. has seemed to be a safe venue for the deployment of investors' funds. This has led to both increased numbers of non-U.S. owned lenders, and to increased levels of non-U.S. investors' direct and indirect funding of commercial lending activities in the U.S.

Commercial Lending: General

Generally, there are few rules applicable to commercial lending; by contrast, consumer-purpose lending is highly regulated at both the federal and state level. Further, the larger the commercial loan in question, the less regulation will generally apply. Of course, commercial lending activities are subject to appliable laws pertaining to fraud, antitrust, unfair business practices, and similar topics. In addition, particular federal statutory schemes such as the Racketeering in Corrupt Organizations Act, the Equal Credit Opportunity Act, the Office of Foreign Assets Control rules ("OFAC"), the USAPATRIOT Act, and the various anti-money laundering-related laws, are applicable to commercial lending activities, both at the corporate level and as to each loan.

Overview: Determining Applicable Law in the U.S. Federal System

Overview: While banks are primarily regulated by the federal government, the regulation of non-bank commercial lending is entirely based on state law. Even where there is federal government support for commercial lending activity, such as Small Business Administration-guaranteed loans, the loan instruments themselves are made with reference to state law and must be enforced, if necessary, primarily in state courts. Therefore, a discussion of non-bank commercial lending must focus primarily on state law.

This, in turn, leads to a state-by-state analysis of several factors, primarily:

- State licensing laws: must a non-bank lender be licensed in any particular state?
- State usury laws: is a particular loan subject to the usury laws of any particular state?
- Choice-of-Law Provisions: may a loan agreement apply the laws of any particular state to the interpretation and enforcement of the loan agreement?

The Crucial Issue: Loan Situs: These three issues are interrelated, and pertain to the underlying question: which state is the situs of the loan? As will be discussed below, that question is to some extent governed by the domiciles of the borrower and/or lender, and to some extent can be established by the loan agreement.

Licensing

Licensing Generally: The first question is whether a state license is required for the lender to make a commercial loan. State commercial loan licensing laws were almost all enacted decades ago, generally prior to the explosion in interstate lending of the past 40 years. Therefore, it is not always easy to determine whether a particular loan transaction requires licensing by the lender.

The simplest analysis applies where the lender and the borrower are both domiciled in a particular state, the loan will be funded in that state, and the loan funds will be utilized in the state. In such cases, it is easy to conclude that the law of that state will apply to the transaction, and that cannot be changed by the loan agreement. In such event, if the lender is required by the laws of that state to be licensed, it must comply.

The analysis becomes more complex if the lender and the borrower are domiciled in different states. In such circumstance, the most conservative interpretation is that the lender should be licensed in the state of the borrower's domicile. This is generally the solution that the state regulators would most like to see, and the situation in which it will be simplest to enforce the loan obligation in the courts of the state of the borrower's domicile. Some states are particularly aggressive in asserting licensing obligations, the primary example being California. Other states, however, such as Nevada, have also been known to assert the applicability of such licensing requirements.

Further complication can arise where the borrower is domiciled in one state, and has its principal place of business in another state. On the one hand, it would seem inconsistent and inequitable for such a borrower to be able to raise a licensing issue where its lender is licensed in one of those two states. On the other hand, a cautious lender must prepare for such an eventuality.

The most conservative course of action is for the lender to be licensed in the state of the borrower's domicile or principal place of business, as applicable[1]. This will certainly preclude any licensing-based challenge to the enforceability of the loan agreement.

Unlicensed Structure: An alternative structure is for the commercial lender to establish its operations in a state that does not require licensing for commercial lending; does not have usury restrictions on commercial loans; and has generally business-friendly courts. For example, some commercial lenders operate out of states such as Utah, Delaware, South Dakota, and Idaho; utilize loan agreements that contain strong choice-of law provisions applying the laws of their home states and thus assert the ability to charge unrestricted interest rates and enforce their loan agreements, at least initially, in friendly courts.

However, to be viable, this structure requires that the lender's operations are genuinely run out of the selected state, because that establishes the nexus described below for application of the law of such state to the loan transaction. It is not sufficient for the lender merely to be incorporated in a friendly state, or even to be licensed in a friendly state but to run its operations out of a different state: in that situation, the lender will probably not be able to assert the laws of the friendly state in its loan agreement. Both regulators and the courts can be expected to regard such arrangements as shams, and to you challenge the enforceability of those loan agreements.

Usury

The next question is whether a particular loan is usurious under applicable law. This analysis first requires a determination of the situs of the loan. As with the licensing requirements, the applicable usury law would initially appear to be that of the borrower's domicile, but may be determined by applying the law of the state agreed to in the loan agreement as appropriate.

Also relevant here is the so-called "usury savings clause." Such a clause provides that if interest payments exceeded the maximum legal rate, any excess paid will be applied toward principal. Courts will generally hold that a loan agreement that provides for an interest rate in excess of the usury limit, but that contains a "savings clause," is not usurious, will reform the loan

[1] The state of incorporation of the borrower or the lender is irrelevant, as that is not significant to the determination of where the corporation's head office or principal place of business are.

agreement to apply the applicable lawful interest rate; and will otherwise enforce the loan agreement. A sample usury savings clause looks like this:

> The parties hereto intend to conform strictly to the applicable usury laws. It is the intention of the parties that this Agreement shall not be subject to the usury laws of any state other than the State of California. Therefore, in no event, whether by reason of demand for payment or acceleration of the maturity of the Loan or otherwise, shall the interest contracted for, charged or received by Lender hereunder or otherwise exceed the maximum amount permissible under applicable law. If, from any circumstance whatsoever, interest would otherwise be payable to Lender in excess of the maximum lawful amount, the interest payable to Lender shall be reduced automatically to the maximum amount permitted under applicable law. If Lender shall ever receive anything of value deemed interest under applicable law which would apart from this provision be in excess of the maximum lawful amount, an amount equal to any amount which would have been excessive interest shall be applied to the reduction of the principal amount of the Loan in the inverse order of its maturity and not to the payment of interest, or if such amount which would have been excessive interest exceeds the unpaid Principal Debt, such excess shall be refunded to Borrower. All interest paid or agreed to be paid to Lender shall, to the extent permitted by applicable law, be amortized, prorated, allocated and spread throughout the full stated term of such indebtedness so that the amount of interest on account of such indebtedness does not exceed the maximum permitted by applicable law.

With regard to usury, too, the most conservative course of action is for the loan agreement to conform to the usury law of the state of the borrower's domicile or principal place of business, as applicable. This will in all likelihood preclude a successful usury-based challenge to the enforceability of the loan.

Choice of Law

Choice-of-Law Provisions: The final major topic is the determination of which state's law applies to the interpretation and enforcement of the loan agreement. Note that these are two different issues, because a court located in one state may apply the law of another state to a litigation matter if appropriate. Every loan agreement should contain a so-called "choice-of law" provision that sets forth the governing law. First, if both lender and borrower are located in the same state, that state's law should be applied. Second, if such is not the case, the loan agreement may always apply the law of the borrower's state. Third, if the lender and borrower are domiciled in different states, the parties may agree that the loan agreement will apply the law of any state that has a substantial nexus to the loan transaction. This last approach has been recognized on a nationwide basis since a 1927 ruling of the U.S. Supreme court to this effect. (*Seeman v. Philadelphia Warehouse Co*., 274 U.S. 403 (1927).

Accordingly, it is common for a lender located in one state to include a choice-of law provision in its loan agreement that applies the law of the lender's domicile, such as:

> The legal relationship between the parties to this Agreement, including any Guarantors, pertaining to this Agreement and otherwise, including any claim, dispute or controversy (whether in contract, tort, or otherwise) at any time arising from or relating to this Agreement or otherwise, is governed by, and this Agreement will be construed in accordance with, applicable federal law and (to the extent not preempted by federal law) Utah law without regard to internal principles of conflict of laws. The legality, enforceability and interpretation of this Agreement and the amounts contracted for, charged and reserved under this Agreement will be governed by such laws. Borrower understands and agrees that (i) Lender is located in Utah, (ii) Lender makes all credit decisions from Lender's office in Utah, (iii) the Loan is made in Utah (that is, no binding contract will be formed until Lender receives and accepts Borrower's signed Agreement in Utah), (iv) Loan disbursements are directed from and made in Utah; (v) Borrower's payments are not accepted until received by Lender in Utah, and (vi) Borrower's agreement to the applicability of Utah law is a determinative factor in Lender's agreeing to enter into the Loan and this Agreement, without which Lender would not agree to do so.

Under the rule of the *Seeman* case, the parties to a loan agreement cannot just pick any state because one or both parties like the law of that state. For example, the mere fact that one of the parties is incorporated in Delaware is not a basis for the application of Delaware law[2]. However, if the lender or borrower is domiciled in Delaware, then a choice-of law provision such as that set forth above would be appropriate under *Seeman*.

If there is such a reasonable nexus between state whose law is chosen to govern the loan agreement and the parties to the transaction, or the transaction itself, then the loan agreement can provide that the laws of that state will govern interpretation of the loan agreement. Further, that choice-of law provision should be enforceable in the courts of both the state designated in the loan agreement, and the state of the borrower's domicile or principal place of business, so long as the terms of the loan agreement do not contravene a significant public policy of that state[3].

Choice of Forum Provisions: A related concern is the choice of dispute forum provision. It is common for a loan agreement to provide that any dispute must be litigated where the lender's home office is located. Then, after the lender obtains a judgment (either a default judgment or a judgment on the merits), it can seek to enforce that judgement in the state in which the borrower's

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[2] See footnote 1. While incorporation in Delaware may serve to apply Delaware law to corporate governance and securities matters, it will not serve to apply Delaware law to substantive operations of the corporate involving non-Delaware third parties. The exception to this would be where the parties expect the loan agreement to be performed in Delaware.

[3] For example, a court in Mississippi, where cannabis is not lawful, might refuse to enforce a loan agreement where the funds are to be used for cannabis production, sale, or distribution.

assets are located. This structure is generally sound: however, there is always some chance that the court in the borrower's home state will refuse to cooperate in the enforcement of the judgment from the lender's state on the grounds that the structure of the loan agreement, including the choice of forum, was unfair to the borrower.

Here, the particular state law chosen can be important. If the state whose law is chosen has a strong regulatory and enforcement scheme, then courts in other states will look at that choice-of-law provision more favorably. Thus, a choice-of-law provision in a loan agreement that applies California or New York law is more likely to be enforced by a court in North Carolina than is an Idaho choice-of-law provision. That is because California and New York have strong licensing and enforcement schemes, and a strong body of commercial statutory and case law, while Idaho does not.

Arbitration: For this reason, arbitration might be a better course of action. Even before the pandemic shutdown, the arbitration services were moving toward managing their proceedings remotely. Such a procedure has been strengthened by collective experiences during the shutdown. It thus seems that the safer approach would probably be to seek to enforce a defaulted loan agreement through arbitration, and then seek a judgment in the state in which the borrower's assets are located based on the arbitration decision.

Special Concerns

Finally, there are several issues that are currently the subject of significant discussion and controversy in the regulatory and commercial lending community. These considerations are not strictly legal in nature, but are relevant to the lender's risk management considerations. These relate to the courts' reluctance to enforce loan agreements that are viewed as unfair to the borrower, and to regulators' efforts to prevent licensed lenders from imposing loan agreements that are viewed as unfair upon their borrowers.

Loan Amount: There are several threshold principal amounts that commercial lenders should be aware of. Whether or not any of those amounts specifically applies to a particular transaction, they are useful guideposts to risk quantum. Those amounts are as follows:

- State Small Loan Amounts. Many states establish thresholds for small-dollar loans that are provided special protection under state law. For example, Alabama applies a lower maximum interest rate on loans for less than $2,000. California provides that any loan for under $5,000 is considered a consumer loan, regardless of its purpose. So, generally, any loan in for less than $,000 should receive special scrutiny;
- $10,000. The next threshold level is in the $10,000 - $15,000 range. For example, California has restrictive interest rates and loan agreement rules for loans under $10,000. Kentucky and Maryland have special rules for loans under $15,000;
- $50,000. New York and New Jersey, New Mexico, Pennsylvania and Oregon lift significant loan restrictions at this level;
- $100,000. Ohio, Delaware and Minnesota lift significant loan restrictions at this level;

- $500,000. Florida lifts significant loan restrictions at this level. The impending commercial financing disclosure requirements of both California and New York will only apply to financings of less than $500,000.

Thus, loans for amounts in excess of $500,000 bear significantly less regulatory or enforceability risk than smaller loans.

Interest Rates: As noted above, the initial interest rate analysis is whether the interest rate exceeds the applicable usury or statutory limitation of the borrower's home state. A loan agreement that complies with the interest rate limitations of the borrower's home state is clearly more easily enforceable in any forum.

Borrower Entities: Loans to sole proprietors are inherently suspect as *bona fide* commercial loans, and carry significant regulatory and enforceability risk on that basis. It seems highly optimistic to expect any level of business or financial sophistication from a business person who cannot, or does not, even form and run his or her business as a single-member LLC. Such a borrower is more likely to claim that he or she did not understand the loan documents or the agreed-to terms of the loan. Worse, the courts and regulators are likely to look with sympathy on such a borrower and to regard the lender as a predator. Therefore, the strong recommendation is that commercial loans only be extended to incorporated business entities[4]. This can include LLC's, LP's, Subchapter C corporations, Subchapter S corporations, and partnerships that have formal written partnership agreements; informal partnerships should be regarded as sole proprietors and avoided as borrowers..

Open-End Credit: All of the considerations set forth in this memorandum are applicable to open-end lines of credit ("LOC's") as well as to closed-end loans. The primary additional consideration is whether the LOC is a *bona fide* open-end product, or is a subterfuge to ensnare the borrower. Here, the major concerns are these:

- The genuine anticipation of repeated transactions within the credit limit: An LOC agreement is much more likely to be enforceable if it provides that the borrower may borrow, repay, and reborrow up to the credit limit throughout the term of the LOC;
- Term of the LOC: An LOC agreement is much more likely to be enforceable if it is for a realistically long term, such that the borrower can expect to be able to use the LOC agreement for some reasonable period of time. There are no guidelines as to what that time should be. However, in the context of commercial lending, anything shorter than a year seems suspect, and longer is better.

Guarantees: It is not unusual for a commercial lender to take a personal guarantee from a principal of a business borrower, or from a third-party who has some interest in seeing the transaction succeed. There is nothing inherently objectionable about this practice. However, there

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[4] As is noted in the attached Survey chart, several states' licensing, usury, and regulatory statutory schemes adopt this distinction.

are numerous defenses to the payment of continuing guarantees, so lenders should view them with a certain amount of skepticism. The primary defense is unity of interest, which is the legal principle that one cannot guarantee one's own debt. Therefore, if the guarantor and the borrower are deemed to be alter egos, the guarantee will not be enforceable. Most commercial lenders are aware of this, and may take commercial personal guarantees primary for psychological reasons: to encourage repayment.

Real Estate Security: Many of the principles set forth in this memorandum are inapplicable, or apply with significant differences, where the commercial loan is supported by real estate security. Many states that do not require licensing for commercial loans that are unsecured or secured by personal property do require licensing for commercial loans secured by real property. Therefore, whenever real property is contemplated as security for a commercial loan, additional care must be taken in addition to the analysis set forth herein.

Moreover, even more care must be taken if the real property security is 1-4 unit residential real property. Many states' laws contain additional protections for loan secured by such property, and may treat them as residential mortgage loans. Therefore, again, additional caution should be exercised in this situation.

Impending Commercial Financing Disclosures: Finally, it is only a question of time before the two biggest states require pre-funding financing cost disclosures to be provided in connection with small commercial financings. Both New York and California have enacted legislation that requires such cost disclosures to be provided to business borrowers businesses obtaining financing in amounts of less than $500,000. These disclosure requirements apply not only to commercial loans, but to factoring, merchant cash advances, leases, and such forms of financing.

The disclosures required by the New York and California statutes are similar, but not identical. National trade associations are seeking to work with the regulators in New York and California to conform those disclosures, but it is unclear how successful those efforts will be. Both states are in the process of promulgating regulations setting forth the final details of the required disclosures. The current expectation is that such disclosures will promulgated be in final form in mid-2022, with probable effective dates of January 1, 2023.

Summary of State Laws

Exhibit 1 to this memorandum is a general Summary of the licensing and usury provisions of each state pertaining to commercial lending. Please note that this Summary is intended to be used as a general reference. State statutes, case law, and regulatory agency issuances change frequently, so a commercial lender should not rely on the contents of this Summary in entering into a loan or designing a loan product without confirming the information set forth in it, and should seek specific legal advice as to particular situations.

General Recommendations

(1) Determine the situs of the loan. This almost always needs to be (a) the state of the borrower's principal place of business or head office, or (b) in accordance with a reasonable choice-of law provision that has a reasonable connection to the transaction, the state in which the lender is either (i) licensed or (ii) where its operations are located, if that state does not require a license.

(2) Document the loan accordingly: choice-of law provision, usury savings clause, etc.

(3) In the loan structure and documentation, consider the special problems discussed above.