

FTC Investigates Small Business Financing Based on Expansive View of UDAP Authority



ALERT | June 7, 2019

Mark T. Dabertin | dabertinm@pepperlaw.com

On May 23, the FTC launched an investigation into potentially unfair or deceptive practices in the small business financing industry, including by merchant cash advance providers. Although the launch of the investigation was widely reported by the financial services press, the reports failed to mention that the FTC's plans rely on its authority under section 5 of the FTC Act to prosecute unfair and deceptive acts or practices (UDAP) in policing business-to-business activities. Consistent with the ordinary understanding of the word "consumer," the FTC's exercise of its UDAP authority historically has largely been reserved for addressing conduct directly affecting natural persons who engaged in transactions for personal or household purposes.¹

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The newly announced FTC investigation follows closely on the heels of the agency's May 8 workshop, titled "Strictly Business – An FTC Small Business Forum on Small Business Financing." At the conclusion of the forum, FTC Bureau of Consumer Protection Director Andrew Smith explained (available at: <https://www.ftc.gov/news-events/audio-video/video/strictly-business-ftc-forum-small-business-financing>) his views on the applicability of the agency's UDAP authority to small business financing, stating:

As Commissioner Chopra mentioned this morning [in his opening comments to the forum], we at the FTC think that we have a special role to play. Unlike other federal regulators, we're not constrained by personal, family or household purposes. That our statute, our organic statute, the FTC Act, allows us to address unfair and deceptive practices even with respect to businesses. And I want to make clear that we believe strongly in the importance of small businesses to the economy, the importance of loans and financing to the economy. . . . But we believe equally in protecting small businesses from unfair and deceptive practices. . . . The FTC Act gives us broad authority to stop deceptive and unfair practices by nonbank lenders, marketers, brokers, ISOs, servicers, lead generators and collectors.

Director Smith elaborated that "protecting small businesses is nothing new for the FTC" and invited participants to consider the "dozens of enforcement actions" involving small businesses that the FTC pursued during 2018 in connection with an initiative called "Operation Main Street."

In Operation Main Street, the FTC joined with the offices of eight state attorneys general, the New York Division of the U.S. Postal Inspection Service, two U.S. Attorneys' offices and the Better Business Bureau (BBB) to identify and prosecute fraud affecting small businesses. On June 18, 2018, the FTC issued a press release (available at: <https://www.ftc.gov/news-events/press-releases/2018/06/ftc-bbb-law-enforcement-partners-announce-results-operation-main>) reporting on the status and success of 24 separate actions that resulted from this initiative. In the press release, FTC Chairman Joe Simons stated, "Millions of U.S. consumers either own or work at small businesses nationwide, and the FTC is happy to join with our law enforcement partners and the BBB to help stop scams and spread the word about how they can identify and avoid scams targeting their livelihood."

A review of the Operation Main Street enforcement actions highlighted in the FTC's press release indicates that, although these actions involved small businesses, the FTC viewed them as consumer in nature. For example, in a release (available at: <https://www.ftc.gov/news-events/press-releases/2018/06/ftc-bbb-law-enforcement-partners-announce-results-operation-main>) summarizing the FTC's enforcement actions against one business, it stated, "the consumers — who are often small businesses — never ordered or agreed to buy anything from the defendants and were not previously sent an invoice."

Furthermore, although the FTC at times rhetorically refers to the small business entity as a "consumer," a closer review of these actions reveals that the FTC was seeking to protect the interests of the owners and employees of the business, and not the corporate entity itself. In any event, the FTC's position regarding what constitutes a "consumer" poses a number of questions regarding how the agency should be expected to wield its UDAP authority with respect to small business financing in the future.

We are aware of a single court decision in which the FTC's broad view of what constitutes a "consumer" for purposes of section 5 was directly challenged. In *FTC v. IFC Credit Corp.*,² which was a motion to dismiss action brought by the defendant leasing company, the District Court for the Northern District of Illinois, Eastern Division, considered whether small businesses and not-for-profit organizations constitute consumers for purposes of section 5. In doing so, the court noted that the issue was a matter "of first impression, and that no prior case ha[d] explicitly dealt with the question."³

In upholding the FTC's broad interpretation of the term "consumer," the court in *FTC v. IFC Credit Corp.* stated that "[i]t would not have been a difficult feat of draftsmanship for Congress in subsection (n) to have restricted the operation of the [FTC Act] to those unfair practices that affect individuals purchasing household goods for personal use."⁴ In this regard, the defendant cited to the Magnuson-Moss Warranty Act, which deals with warranties on household goods, as an example of a law where the meaning of the term "consumer" is linked to the purchase of a consumer goods or services. Instead of viewing the Magnuson-Moss Warranty Act as narrowing the definition of "consumer," however, the court treated it as proof that Congress could have adopted a narrower definition of that term in the FTC Act if had desired to do so.

The court also reviewed the FTC Act's legislative history, noting that the term "consumer" has been construed narrowly at times, but rejecting the idea that the existence of past narrow interpretations during the Act's long existence precluded an expansive interpretation in the present:

Thus, rather than reflecting vacillation, the FTC's prior use of a restrictive definition reflects an exercise of that flexibility in response to perceived evils. In any event, "[t]he fact that the agency has from time to time changed its interpretation of [a] term . . . does not . . . lead us to conclude that no deference should be accorded the agency's interpretation of the statute." *Chevron U.S.A., Inc.*, 467 U.S. at 863.⁵

The court then cited public policy reasons for supporting the FTC's interpretation, concluding that "dilution of the FTC's authority [to interpret section 5] would be to exclude from regulation literally millions of transactions that occur on a daily basis, regardless of how deceptive or unfair the acts or practices that prompted those transactions might be."⁶ In addition, the court evaluated various competing dictionary definitions of the term "consumer." To this end, the court opined that the lack of a single agreed-upon definition of "consumer" supported the conclusion that the term is open to interpretation.⁷

With the exception of the Equal Credit Opportunity Act, federal financial consumer protection laws generally do not apply to conduct that is primarily business versus consumer in nature. For example, with the exception of narrowly drawn regulatory rules governing credit card lending, the requirements of the Truth in Lending Act (TILA) are inapplicable to business-purpose lending. In addition, the Electronic Funds Transfer Act, the Fair Debt Collections Practices Act, and the Telephone Consumer Protection Act likewise only apply to consumers. Finally, the Fair Credit Reporting Act similarly only applies to consumers, and its requirements are routinely adhered to whenever a credit report on an individual is obtained, regardless of whether the underlying purpose for the report relates to a commercial or consumer transaction.

The potential for conflict between the UDAP authority of section 5 and other federal consumer protection laws is illustrated by the FDIC's 2009 cease-and-desist order against Advanta Bank concerning alleged unfair and deceptive practices relating to the issuance and servicing of business-purpose credit cards. As noted above, with few exceptions, Congress exempted business-purpose credit from the protections of the TILA. In this regard, as in the case of the Magnuson-Moss Warranty Act, the coverage of the TILA hinges on the consumer nature of the transaction. Because the TILA did not

apply, the FDIC chose to cite the alleged wrongful conduct as violations of section 5. This FDIC action ended in a nonjudicial settlement, with the result that no court was called on to consider the conflict between the FTC's use of section 5 and the coverage of the TILA.

When a person elects to do business as a corporation or limited liability company, they acquire certain legal protections, most notably the ability to shield their personal assets against losses that may be suffered by the business. At the same time, it is generally accepted that these persons forgo certain legal protections that would have continued to apply to them had they chosen to remain consumers. To this end, by incorporating, a person sends a clear message to the business community that they are willing and able to negotiate with other businesses on an arms-length, equal basis. This is a necessary presumption for contracting parties in order for business commerce to proceed; *i.e.*, a party to a transaction should not have to stop and consider whether the other party might be considered a "consumer" with the ability to unwind what was agreed to. The court in *FTC v. IFC Credit Corp.* paid short shrift to these consequences, noting that "[i]t is not the role of courts to gainsay those policy choices."⁸ However, the FTC's newly announced emphasis on policing small business financing could bring these adverse impacts on commerce to the forefront.

The FTC's interpretation of section 5, as articulated by Director Smith, potentially throws the applicability of the federal consumer protection laws into confusion, as business conduct that falls squarely outside the scope of a given statute could nevertheless be cited as a violation of UDAP. Consistent with the FDIC's Advanta order, the FTC may not feel constrained to pursue enforcement action even when a relevant federal consumer protection law only applies to transactions concerning personal, family or household purposes by its terms.

Pepper Points

- The FTC's plan to investigate small business financing is a significant development. However, the agency's stated legal basis for pursuing potential enforcement actions against persons engaged in that industry under an expansive reading of section 5 of the FTC Act arguably presents the bigger news, as it opens the door to introducing federal consumer protection laws into all manner of business-to-business conduct.
- The legal position that a person is acting as a "consumer" within the meaning of section 5 of the FTC Act when they own and operate a small business is virtually untested in court actions and raises a number of important questions. For example,

at what point does a business become too big to require the protections of the federal consumer financial protection laws? In addition, in view of *FTC v. IFC Credit Corp.*, how a given federal statute defines “consumer” may make a difference in determining whether the substance of that statute will be applied to business activities through section 5.

- The CFPB’s jurisdiction is restricted by the Dodd-Frank Act to matters involving “consumer financial products and services.” According to Director Smith, the FTC’s jurisdiction is not similarly constrained with respect to small businesses. Anyone doing business with a smaller-sized business entity should assume that that entity may be deemed covered by the full panoply of federal financial consumer protection laws under the guise of section 5 down the road, which could have the effect of voiding what was agreed to.

Endnotes

- 1 See e.g., J. Howard Beales, former FTC Bureau of Consumer Protection Director, “The FTC’s Use of Unfairness Authority: Its Rise, Fall, and Resurrection” (May 30, 2003) (“In 1938, the FTC Act was amended to prohibit ‘unfair or deceptive acts or practices’ in addition to ‘unfair methods of competition’ — thereby charging the FTC with protecting consumers directly, as well as through its antitrust efforts.”).
- 2 543 F. Supp. 2d 925 (N.D. Ill. 2008).
- 3 *Id.* at 929.
- 4 *Id.* at 937.
- 5 *Id.* at 937.
- 6 *Id.* at 938.
- 7 *Id.* at 939.
- 8 *Id.* at 939-940.