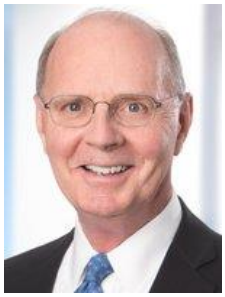
'Buy Now, Pay Later' Services Face Increased Calif. Regulation

By **John Collins, Stephanie Sheridan, Josh Oppenheimer and Meegan Brooks** (May 15, 2020)



John Collins

Stephanie Sheridan

Josh Oppenheimer

Meegan Brooks

As the world continues to adjust to the COVID-19 pandemic, Americans out of work or with reduced salaries are struggling to pay their most basic bills. In an effort to stretch their dollars, consumers may be attracted to "buy now pay later," or BNPL, payment plans offered by third-party service providers like Afterpay, Sezzle and Quadpay to purchase goods.

These arrangements, which largely originated in Australia and are now surging in popularity in the United States, allow consumers to split their purchases into several smaller — often four — payments. They appeal to retailers because they offer consumers more flexible payment options while the retailers receive full payment upfront from the service providers. Consumers like the immediate gratification of taking their purchases home before making payment in full, as was required by the old-school layaway model.

But as these services enter the mainstream, they have caught the eye of a California financial regulator enforcing its lender licensing regime. Given the current economic climate, these programs will likely gain increased popularity. Retailers offering third-party BNPL options should be aware of the risks in partnering with BNPL service providers.

BNPL: From Under the Radar to Front and Center

BNPL arrangements — also referred to as retail installment sales contracts — are designed to avoid application of certain federal and state laws.[1] For example, the federal Truth in Lending Act's Regulation Z applies only to consumer credit that is subject to a finance charge or is payable in more than four installments. Many state laws also exclude contracts that do not charge interest or finance charges, or require four or fewer payments.

However, BNPL arrangements cannot escape regulatory scrutiny entirely. The California Retail Installment Sales Act (known as the Unruh Act), for example, governs certain BNPL arrangements that provide for payment in more than four installments, contain a finance charge, or where the goods or services are available at a lesser price if paid for by either cash or credit card. Both federal and state installment contract laws also regulate disclosure and substantive requirements.

Earlier this year, California's Department of Business Oversight fined BNPL provider Sezzle $28,200 for operating without a lender's license and forced the company to refund $282,000 to 17,000 Californian consumers, representing the fees it had collected in transactions the Department of Business Oversight concluded were illegal loans.[2] The DBO also made Sezzle obtain a California Financing Law license.

In March, the DBO fined BNPL provider Afterpay for the same violation and also made it obtain a license.[3] On April 22, the DBO did the same with Quadpay.[4] In all of the cases,

the companies entered into consent orders with the DBO without admitting or denying that they engaged improperly in the business of a finance lender in California.

Applying the California Financing Law to BNPL Service Providers

Under the California Financing Law, third parties may purchase a merchant's nonevasive, bona fide credit sales contracts without such purchases necessarily subjecting the transactions to the state's loan laws. Nevertheless, extensive third-party involvement in the underlying credit sale may cause transactions to be deemed loans, regardless of the form.

Boerner v. Colwell Co., the "seminal case differentiating a credit sale from a loan," set the boundary of permissible third-party involvement in an otherwise nonevasive, bona fide credit sale.[5]

First, a transaction may be considered a loan, despite its form, if a third-party's involvement with the merchant goes beyond that necessary to effectuate the purchase of credit sales. Second, a transaction may be considered a loan, despite its form, if the role of the third party and terms of the transaction are not fully disclosed to the consumer. Third, a transaction may be considered a loan, despite its form, if the third party does not bear the full risk of consumer performance under the credit sale.

In the Sezzle action, the DBO first argued that Sezzle structured its merchants' purported credit sales to evade any consumer protection obligations Sezzle may have otherwise owed to consumers under the Unruh Act or the federal Truth in Lending Act by limiting the number of installment payments to four.

It then argued that Sezzle's role caused the transactions to be loans. It proffered that Sezzle's involvement with its merchants goes "well beyond" any nonlending relationship permitted by California courts, and the credit sales purportedly purchased by Sezzle do not justify Sezzle's extensive involvement. In addition to purchasing merchants' credit sales contracts, Sezzle provides merchants marketing services, payment processing services, consumer dispute resolution services, and interest-bearing accounts in which merchants can hold the revenue earned from Sezzle.

The DBO also claimed that consumers using Sezzle are not fully informed of the role of Sezzle or all financing terms. Sezzle reserves the right to unilaterally impose new fees on consumers, and does not disclose the fees merchants pay to it.

Finally, the DBO argued that Sezzle does not bear the full risk of loss from performance on the credit sales contracts it purchases. Its merchant agreement provides Sezzle with an opportunity to review and refuse providing financing for certain consumer purchases, despite the sale having already been processed by the merchant.

In sum, the DBO concluded that Sezzle's purported purchasing of credit sale contracts between merchants and California consumers constitutes the making of loans under California law and, thus, requires a California Financing Law license.[6] In January 2020, the DBO and Sezzle entered into a consent order wherein Sezzle will only provide loans or extensions of credit to California residents under the authority of a license issued under the CFL.[7]

In a related interpretative opinion advising an unnamed BNPL service provider that its products also are considered "loans," the DBO further explained that BNPL financing transactions may be deemed loans when:

1. The consumer, merchant, and third-party financer treat the transactions like loans, despite contradictory language in the applicable contracts;

2. The relationship between merchant and third-party financer is extensive;

3. The role of the third-party financer and all financing terms are not clearly disclosed to the consumer; and

4. The financing transaction is not otherwise regulated.[8]

Retailers Take Heed

California is often the leader in state regulatory actions, and other states may review their lender licensing laws to determine whether those laws apply to BNPL providers. The action also leaves open the possibility that state regulators will expand their financing laws beyond BNPL providers to retailers, depending on how such arrangements are organized.

Retailers currently offering BNPL programs are encouraged to take stock and:

- Assess how their BNPL arrangements are organized — i.e., arrangements that look more like loans than extensions of credit will be viewed as such;

- Understand what additional services their BNPL service provider is offering beyond the credit sales arrangement — i.e., arrangements that go beyond simply effectuating a credit sale may be subject to great regulatory scrutiny;

- Evaluate the level of disclosure provided to consumers about the retailer-BNPL service provider relationship — i.e., regulators may feel that customers less informed about the arrangement need greater government protections;

- Review how their BNPL service provider accepts or declines consumers on its platform — i.e., a BNPL provider that can decline customers sua sponte may be viewed differently than a provider that must accept all of a retailer's customers; and

- Determine what federal and state consumer protection regulations apply – i.e., contractual arrangements that seek to avoid certain federal or state retail installment laws may warrant further oversight.

What was once an Australian phenomenon is now firmly present in the United States, and California has taken note of what laws should apply to BNPL programs.

Retailers should do the same.

John Collins and Stephanie Sheridan are partners, and Josh Oppenheimer and Meegan Brooks are associates, at Steptoe & Johnson LLP.

[1] Stephanie A. Sheridan, et. al, "What's Old Is New Again: The Risks in RISCs (Retail Installment Sales Contracts)," Steptoe & Johnson LLP (July 9, 2019), https://www.steptoe.com/en/news-publications/whats-old-is-new-again-the-risks-in-riscs-retail-installment-sales-contracts.html.

[2] In re Sezzle, Inc., No. 60DBO-104155 (Cal. Dep't Bus. Oversight Jan. 6, 2020) (Consent Order), https://dbo.ca.gov/wp-content/uploads/sites/296/2020/01/settlement-sezzle.pdf.

[3] In re Afterpay, US Inc. (Cal. Dep't Bus. Oversight Mar. 16, 2020) (Consent Order), https://dbo.ca.gov/wp-content/uploads/sites/296/2020/03/afterpay-settlement.pdf.

[4] In re Quadpay, Inc. (Cal. Dep't Bus. Oversight April 22, 2020) (Consent Order), https://dbo.ca.gov/wp-content/uploads/sites/296/2020/04/Quadpay-Consent-Order-Final.pdf.

[5] Front Line Motor Cars v. Webb, 35 Cal. App. 5th 153, 164 (2019) (referring to Boerner v. Colwell Co., 21 Cal. 3d 37 (1978)).

[6] In re Sezzle, Inc., No. 60DBO-104155 (Cal. Dep't Bus. Oversight Dec. 30, 2019) (Statement of Issues), https://dbo.ca.gov/wp-content/uploads/sites/296/2019/12/Sezzle-Statement-of-Issues.pdf.

[7] See supra note 2.

[8] Cal. Dep't Bus. Oversight Op. 7667 (Dec. 20, 2019) (Deferred Payment Products), https://dbo.ca.gov/wp-content/uploads/sites/296/2019/12/Deferred-Payment-Products-cfl.pdf.