

Principles of Business Credit

Eighth Edition

National Education Department

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ESSENTIAL STATUTES FOR THE CREDIT DEPARTMENT

- The Fair Credit Reporting Act
- The Equal Credit Opportunity Act and Regulation B
- Dodd-Frank Wall Street Reform and Consumer Protection Act
- The Fair Debt Collection Practices Act
- The Truth in Lending Act and Regulation Z
- E-Sign Act
- Unclaimed Property Law (Escheatment)
- Sarbanes-Oxley Act of 2002
- Red Flags

THE FAIR CREDIT REPORTING ACT

- Purpose
 - To require consumer reporting agencies to adopt reasonable procedures that meet the needs of consumer credit, personnel (employment), insurance and other information that is fair and equitable to consumers
- Intended to apply **ONLY** to consumer credit transactions and not to commercial credit transactions
- Consumer or personal credit is defined as “credit for personal, family, or household purposes.”

FAIR CREDIT REPORTING ACT IMPORTANT DEFINITIONS

- “Consumer” is “any individual”
- “Consumer Report” is any written, oral, or other communication of any information by a consumer reporting agency bearing on a consumer’s credit worthiness ... serving as a factor in establishing the consumer’s eligibility for –
 - (A) Credit or insurance to be used primarily for personal, family, or household purposes;
 - (B) Employment purposes; or
 - (C) Any other purpose authorized under 1681b of this title

FAIR CREDIT REPORTING ACT IMPORTANT DEFINITIONS

- “Investigative Consumer Report” is a consumer report or portion thereof in which information on a consumer’s character, general reputation, personal characteristics, or mode of living is obtained through personal interviews with neighbors, friends, or associates of the consumer reported on or with others with whom he is acquainted or whom may have knowledge concerning any such items of information.”

PERMISSIVE USE OF CONSUMER REPORT

- In response to the order of a court having jurisdiction to issue such an order, or a subpoena issued in connection with proceedings before a Federal grand jury
- In accordance with the *written* instructions or permission of the consumer to whom it relates
- In connection with a legitimate business need for the information

LEGITIMATE BUSINESS NEED FOR INFORMATION

- In connection with a business transaction that is initiated by the consumer; or
- To review an account to determine whether the consumer continues to meet the terms of the account
- A business transaction in which an individual has accepted personal liability for business debt, such as in the case of a sole proprietor, partner, or guarantor, DOES provide a permissible purpose under Section 604 of the Fair Credit Reporting Act to obtain and use a consumer credit report

NON-PERMISSIBLE PURPOSE

- The Federal Trade Commission has stated that the extension of trade credit to a business was NOT a legitimate business need to obtain a consumer credit report on the owner of the business and insists that written authorization be obtained prior to a trade credit grantor obtaining or utilizing a consumer credit report on that owner.

INDIVIDUAL CREDIT REPORT AUTHORIZATION

- Recommended authorization language
 - *The undersigned is either a sole proprietor, a partner in a partnership, an individual who may be executing a personal guarantee in connection with the extension of credit to Applicant, or one of the principal stockholders of a corporation. I give permission to ___ (trade credit grantor) ___ to obtain and utilize an individual credit report on me personally to determine my creditworthiness.*

EQUAL CREDIT OPPORTUNITY ACT and REGULATION B

- **The Equal Credit Opportunity Act (ECOA) is a federal law that makes it unlawful for any creditor to discriminate with respect to the extension of credit against an applicant on the basis of sex, race, color, creed, national origin, age or marital status.**

ADVERSE ACTION UNDER THE ECOA

- Adverse Action means:
 - Refusal to grant credit in substantially the amount or on substantially the terms requested in an application
 - A reduction of credit availability on an existing account
 - A refusal to increase the amount of credit available to an applicant who has asked for an increase
 - A termination of an account or an unfavorable change in the terms of an account that does not affect all or substantially all of a class of the creditor's accounts

NOT INCLUDED AS ADVERSE ACTION UNDER THE ECOA

- Adverse Action DOES NOT INCLUDE:
 - A change in terms of an account expressly agreed to by an applicant
 - Action or forbearance relating to an account taken in connection with inactivity, default, or *current* delinquency as to that account
 - Refusal because the creditor does not offer the type of credit or credit plan requested
 - Refusal because applicable law prohibits the creditor from extending the credit requested

BUSINESS CREDIT UNDER THE ECOA

- Business Credit refers to extensions of credit primarily for business or commercial (including agricultural) purposes, but excludes extensions of credit in certain types of transactions, such as public utilities, securities and government credit.
- Trade Credit is NOT defined in the ECOA and is encompassed under Business Credit
 - Staff Commentary states “that the term ‘trade credit’ generally is limited to a financing arrangement that involves a buyer and a seller – such as a supplier who finances the sale of equipment, supplies, or inventory; it does not apply to an extension of credit by a bank or other financial institution for the financing of such items”

SIGNATURE OF A SPOUSE PROHIBITED

- The ECOA mandates that a creditor shall NOT require the signature of an applicant's spouse, other than a joint applicant, on any credit instrument (guaranty, security agreement) if the applicant qualifies under the creditors' standards of creditworthiness for the amount and terms of the credit requested.
 - The signature of that spouse may be required if that spouse is directly involved with the business credit applicant
- A creditor shall not deem the submission of a joint financial statement or other evidence of jointly held assets as a joint application for credit
- If a creditor relies upon property that the applicant owns jointly with another person, then the creditor may require the signature of the other person on instruments necessary to reach that property in the event of death or default

COMMUNITY PROPERTY STATES

- A creditor MAY require the signature of the spouse on any instrument necessary, or reasonably believed to be necessary under applicable state law to make the community property available to satisfy the debt in the event of default under certain circumstances
 - If applicable state law denies the applicant power to manage or control sufficient community property to qualify for the amount of credit requested; and
 - The Applicant does not have sufficient separate property to qualify for the amount of credit requested without regard to community property
- A credit grantor should always check with an attorney in each particular community property state to establish the appropriate policies and procedures for each state.

EQUAL CREDIT OPPORTUNITY ACT REQUISITE NOTICE

The federal Equal Credit Opportunity Act prohibits creditors from discriminating against credit applicants on the basis of race, color, religion, national origin, sex, marital status, age; (provided the applicant has the capacity to enter into a binding contract); because all or part of the applicant's income derives from any public assistance program; or because the applicant has in good faith exercised any right under the Consumer Credit Protection Act. The federal agency that administers compliance with this law concerning this creditor is Federal Trade Commission, Equal Credit Opportunity, Washington, D.C. 20580.

EQUAL CREDIT OPPORTUNITY ACT NOTIFICATION REQUIREMENTS

- Business Credit Applicants
 - \$1 million or less – gross revenues in preceding fiscal year
 - Gross revenues in excess of \$1 million OR AN EXTENSION OF TRADE CREDIT
 - Notification within 30 days after
 - Receiving a completed application
 - Taking adverse action on existing account
 - Receiving an incomplete application

EQUAL CREDIT OPPORTUNITY ACT NOTIFICATION CONTENTS

- A statement of the action taken orally or in writing
- Inform applicant of its right to a statement of reasons AND provide the requisite ECOA notice

EQUAL CREDIT OPPORTUNITY ACT NOTIFICATION TIMING & MANNER

- Trade Credit Applicants
 - Notify applicant, within a reasonable time
 - Orally or in writing; and
 - If and only if applicant makes a written request for reasons behind credit decision within 60 days of being notified of adverse action,
 - THEN creditor must provide a written statement of reasons
 - AND requisite ECOA notice

EQUAL CREDIT OPPORTUNITY ACT RETENTION OF RECORDS

With regard to a business that had gross revenues in excess of \$1 million in its preceding fiscal year, or an extension of trade credit, credit incident to a factoring agreement, or other similar types of business credit, the creditor shall retain records for at least 60 days after notifying the applicant of the action taken. If within that time period the applicant requests in writing the reasons for adverse action or that records be retained, the creditor shall retain records for 12 months.

THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT OF 2010 IMPACT ON ECOA COMPLIANCE

- Creditors that make adverse decisions based on information in an applicant's consumer report must disclose
 - The numerical credit score used in taking the action
 - The range of possible credit scores under the model used
 - Key factors (up to 4) that adversely affected the consumer's credit score and the model used
 - Date on which credit score was created
 - Name of the consumer reporting agency or other person or entity that provided the credit score or the credit file upon which the credit score was created
 - Statement explaining credit scores

THE FAIR DEBT COLLECTION PRACTICES ACT

- Created to protect consumer debtors from abusive, deceptive and unfair debt collection practices
- Consumer debts are defined as debts incurred primarily for personal, family or household purposes
- Applies to third-party debt collectors such as collection agencies and collection attorneys
- Applies to debt buyers

THE FAIR DEBT COLLECTION PRACTICES ACT

- Creditors collecting their own debts in their own name are generally Exempt
 - Certain State laws may hold creditors liable for abusive, deceptive or unfair debt collection practices
 - California, Texas and Florida impose liability on creditors collecting their own debt
 - Texas and North Carolina impose substantial restrictions on creditors

THE FAIR DEBT COLLECTION PRACTICES ACT

- The following is a partial list of the practices prohibited by the FDCPA:
 - Misrepresenting the character or amount of a debt.
 - Threatening to take action prohibited by law.
 - Threatening to take action that is not intended to be taken.
 - Using profane, obscene or abusive language.
 - Making repeated calls for the purpose of harassment.
 - Reporting a disputed debt to a credit bureau without disclosing that it is disputed.
 - Reporting a “stale” debt to a credit bureau
 - Suing or threatening to sue on a time-barred debt.
 - Filing a proof of claim on a time-barred debt in a bankruptcy proceeding may or may not be a violation of the FDCPA

The Truth in Lending Act and Regulation Z

- Protects and educates consumers about obtaining consumer credit
- Promotes the informed use of consumer credit by requiring disclosures about its cost and terms
- Protects consumers against inaccurate and unfair credit billing and credit card practices
- Provides consumers with rescission rights.
- Provides for rate caps and minimum standards on many certain dwelling-secured loans
- Imposes limitations on home equity lines of credit (HELOC) and certain closed-end home mortgages.
- Delineates and prohibits unfair or deceptive mortgage lending practices

The Truth in Lending Act and Regulation Z

- Exempted from TILA
 - Credit extended primarily for a business, commercial, or agricultural purpose
 - Credit extended to other than a natural person (including credit to government agencies)
 - Credit in excess of an annually adjusted threshold not secured by real property or by personal property used or expected to be used as the principal dwelling of the consumer.
 - Public utility credit.
 - Credit extended by a broker-dealer registered with the U.S. Securities and Exchange Commission or the U.S. Commodity Futures Trading Commission, involving securities or commodities accounts.
 - Home fuel budget plans not subject to a finance charge.
 - Certain student loan programs.

The Truth in Lending Act and Regulation Z

- The Truth in Lending Act was amended in 1975 to create **The Fair Credit Billing Act**
 - Intended to remove the hassle out of billing errors for consumers
 - Errors are required to be corrected promptly with steps to prevent errors from showing up on consumer reports

THE ELECTRONIC SIGNATURES IN GLOBAL AND NATIONAL COMMERCE ACT “E-SIGN ACT”

The E-Sign Act set the enforcement of electronic communications in motion and provided a template for laws governing electronic signatures and communications subsequently put in place throughout the country.

In Section 7001(a), the E-Sign Act provides:

1. A signature, contract, or other record relating to such transaction may not be denied legal effect, validity, or enforceability solely because it is in electronic form; and
2. A contract relating to such transaction may not be denied legal effect, validity, or enforceability solely because an electronic signature or electronic record was used in its formation.

E-Sign Act defines **electronic signature** as an electronic sound, symbol, or process, attached to or logically associated with a contract or other record and executed or adopted by a person with the intent to sign the record.

Electronic Signatures and Credit

For the credit professional, an e-signature may eliminate a customer's need to download an application and mail the completed application with a handwritten signature. Some of the relevant provisions of the E-Sign Act are:

- Parties to the contract decide on the form of digital signature technology to validate the contract.
- Businesses may use e-signatures on checks.
- Businesses must require parties to the contract to make at least two clicks of a computer to complete a deal.
- The customer decides whether to use an e-signature or handwritten signature.
- Cancellation and foreclosure notices must be sent on paper.
- E-signatures on adoptions, wills, and product safety recalls are not allowed.
- Records of e-contracts may be stored electronically.

Unclaimed Property Law (Escheatment)

Tangible or intangible property owed to a person or entity (the owner), yet held by another (the holder).

- An account's credit balance may qualify
- State becomes legal owner
- States consider it a source of revenue
- All States, the District of Columbia, U. S. Virgin Islands, Puerto Rico, and Guam have enacted unclaimed property laws
- The Uniform Unclaimed Property Act is the predominant statute governing escheatment

Unclaimed Property Law (Escheatment)

- **Uniform Unclaimed Property Act**
- **Adopted by:**
 - ▶ Alabama, Arizona, Arkansas, Hawaii, Indiana, Kansas, Louisiana, Maine, Michigan, Montana, Nevada, New Mexico, North Carolina, U.S. Virgin Islands, Vermont, West Virginia
 - ▶ Most other states have adopted some form of the Uniform Unclaimed Property Act.
- **Revised Uniform Unclaimed Property Act**
 - Completed by the Uniform Laws Commission in 2016
 - Enacted to date **ONLY** by Delaware
 - Legislation has been introduced in Illinois, Nebraska, Tennessee, Utah

Unclaimed Property Law (Escheatment)

- Property is unclaimed if, for applicable period (generally 3 to 5 years), the apparent owner has not communicated in writing or by other means reflected in a contemporaneous record prepared by or on behalf of the holder, and has not otherwise indicated an interest in the property
- Report must be filed with the State Controller
 - Description of the property
 - Name, last known address
 - SS number or taxpayer id number
 - The date, if any, on which the property became payable, demandable, or returnable, and the date of the last transaction with the apparent owner of the property
- Cash payments are made payable to the State Treasury where the owner of the property was last located

Unclaimed Property Law (Escheatment)

- **Business-to-Business Exemption**
 - Some states choose not to interfere with business relationships
 - Some states allow businesses to hold the property without an ongoing business relationship provided an attempt is made to return the property to the rightful owner
- **Risk of Not Escheating**
 - Harsh penalties
 - Interest, fines and damages
- **Escheatment Audit**
 - Can go back several years
 - Financial documents are required

Steps to Protect Against Escheatment Claims

1. Determine the situation
2. Determine eligible property
3. Perform the due diligence
4. Prepare reports and remittances
5. File reports and remittances
6. Follow up and reconcile

Sarbanes-Oxley Act of 2002

Law developed following Enron, Tyco and WorldCom bankruptcy fraud cases

The principal objectives addressed in the Act can be grouped into the following themes:

- To strengthen and restore confidence in the accounting profession;
- To strengthen enforcement of the federal securities laws;
- To improve the “tone at the top” and executive responsibility;
- To improve disclosure and financial reporting; and
- To improve the performance of “gatekeepers.”

Sarbanes-Oxley Act of 2002

- Public Company Accounting Oversight Board established as a watchdog for public companies to ensure informative, accurate and independent audit reports
- Auditor Independence prohibits any registered public accounting firm to provide any non-audit related services
- Corporate Responsibility places the burden for proper audit procedures and financial reporting on the principal executive officer or officers and the principal financial officer or officers
 - Other persons can be assigned this responsibility
 - Credit managers are often asked to sign off on documentation about accounts receivable and credit risk.

Section 404

- Section 404 mandates that companies evaluate the effectiveness of their internal controls by having their certifying officers consider two basic questions:
 1. Do the employees of the company understand what they need to do to properly prepare external financial reports?
 2. What information do the company officers need to make sure their employees have complied?
- Three steps can help address these two questions:
 - Identify financial reporting risks and the controls that address them.
 - Ensure that the controls work in practice.
 - Report the conclusions on overall effectiveness and deficiencies.

Section 302

- Section 302 Certification requirements
 - The signing officer has reviewed the report;
 - Based on the officer's knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading;
 - Based on such officer's knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report
 - Establishing and maintaining internal controls
 - Designing such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared
 - Have evaluated the effectiveness of the issuer's internal controls as of a date within 90 days prior to the report; and
 - Have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date

Sarbanes-Oxley Importance to Credit Managers

- Do not allow anything that does not seem to be right about the way in which credit and receivables are being reported
- Important Documents to keep
 - Credit applications
 - Loan documents
 - Analyses
 - Financial data
 - Memoranda
 - Letters and emails

Red Flags

Red Flags are any pattern, practice or specific activity that indicates the possible risk of identity theft; companies need to identify the Red Flags specific to it by identifying the types of accounts offered or maintained.

The Fair and Accurate Credit Transactions Act of 2007 requires financial institutions and creditors to develop and implement Red Flags programs

The Red Flag Program Clarification Act of 2010 limits the applicability of the Red Flag Rule to a creditor that regularly and in the ordinary course of business:

- Obtains or uses consumer reports in connection with a credit transaction
- Furnishes information to consumer reporting agencies in connection with a credit transaction; or
- Advances funds to or on behalf of a person based on its obligation to repay the funds
 - “Advances funds” refers to money, not goods or services

Red Flags

Red Flags Program

Part I: Risk Assessment to Identify Relevant Red Flags

- Business must first assess the level of risk
 - Creditors dealing with small businesses and personal guarantors have a high risk level
 - Creditors dealing only with large corporate customers and no personal guarantors do not have to comply with the Red Flags Rules
 - Examples:
 - A customer using a credit card for payment and does not have the proper identity code
 - A customer ordering an unusual quantity or type of product
 - A customer requesting delivery to a new or unusual location

Red Flags

Red Flags Program

Part II: Detect Red Flags

- Verify any new or unusual locations
- Contact customer personally if any information or request seems unusual]
- Verify customer even exists which is using a cell phone only
- Verify an email account if it appears generic
- Confirm that the business or person you are dealing with really exists

Red Flags

Red Flags Program

Part III: Respond Appropriately to any Red Flags Detected to Prevent and Mitigate Identity Theft

- Program should set forth a procedure for how you are going to deal with them.
- Response may be as simple as contacting the customer for further verification; or
- Response could include notifying law enforcement officers

Red Flags

Red Flags Program

Part IV: Update the Written Program Periodically to Reflect Changes in Risks to Customers or to Business from Identity Theft

- Proper training of all personnel is required
- Periodic review of your “Red Flags” program is required
- Board of Directors must write and administer the “Red Flags” Program – or
- A Senior Executive (e.g. credit manager) may be designated as the responsible person to write and administer the program.

Red Flags

Red Flags Program

Part V: Oversight of the Red Flags Program

- **The FTC requires oversight by:**
 - **Board of Directors**
 - **A Committee of the Board of Directors**
 - **Designated Senior Management**

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