High Yield for Investors in Specialty Finance

Exploring Opportunities in Factoring and Merchant Cash Advance

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HIGH YIELD FOR INVESTORS IN SPECIALTY FINANCE: EXPLORING OPPORTUNITIES IN FACTORING AND MERCHANT CASH ADVANCE*

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EXECUTIVE SUMMARY

Specialty Finance, broadly defined, includes any financing activity that occurs outside the traditional banking system.[3] Though specialty finance includes both investment banking and asset-based lending, this article will focus only on those products that meet the short-term funding needs of small- to medium-sized businesses. Specifically, we will look at the factoring of accounts receivable and merchant cash advance (MCA) contracts, both of which are currently generating considerable interest among sophisticated investors. Carefully undertaken, factoring and MCA can provide attractive investment opportunities.

The overall decline in bank lending to small business since the Great Recession (late 2000s through early 2010s) has been disquieting because of the importance of this sector in the American economy. Small businesses employ half the private sector workers in the United States and have been responsible since 1995 for the creation of two out of every three net new jobs.[4] Small companies are responsible for 42% of private sector payroll, 43% of high-tech employment, and 33% of the value of exported goods.[5] Historically, bank loans were a primary source of capital for smaller firms; yet, the banking industry reports that small business loans on their books are down 20% since the financial crisis while loans to larger companies are up 4% over approximately the same period.[6] Although not directly comparable to the period since the Great Recession, MCA contracts were estimated by one study to reach $15.3 billion in 2017, from an estimated $8.6 billion in 2014, a compound annual growth rate of 21.1%.[7]

After a slow start from the depth of the Recession, small businesses are now back to providing two-thirds of net new employment in the U.S. and revenue growth is again comparable to the overall increase in U.S. Gross Domestic Product.[8] This has occurred despite the decline in bank lending the sector experienced. Alternative lenders and their increased use of factoring and MCA have filled some of the gap left by traditional banks when the Recession and government-mandated capital requirements forced the banks to largely abandon small business funding.

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[3] William Blair, Specialty Finance Industry Insights, Robert Metzger, J. Young and Kegan Greene, December 2014.
[4] https://www.hbs.edu/faculty/.../15-004_09b1bf8b-eb2a-4e63-9c4e-0374f770856f.pdf, The State of Small Business Lending: Credit Access during the Recovery and How Technology May Change the Game, Harvard Business School, Working Paper by Karen Gordon Mills and Brayden McCarthy, dated July 22, 2014, page 3.
[5] https://www.sba.gov/sites/default/files/FAQ_Sept_2012.pdf, SBA Office of Advocacy Frequently Asked Questions (2012 data).
[6] Small Business Lending: Credit Access, Mills and McCarthy, page 4.
[7] https://www.pymnts.com/in-depth/2016/how-long-can-mcas-avoid-the-loan-label/.
[8] https://www.forbes.com/sites/sageworks/2016/01/17/the-state-of-u-s-small-businesses-entering-2016/#1438da9e2f0b, by Mary Ellen Biery, Forbes reports that businesses with less than $5 million in annual revenue saw an increase in sales growth of 7.8% in 2015.

Factoring involves the sale of a present stream of revenue, whereas Merchant Cash Advances involve the sale of a future stream of revenue.

Factoring is a contract to sell a company's existing accounts receivable, i.e., a ***present stream of revenue***, in return for the immediate receipt of a percentage of the invoices (generally from 70 to 85%, depending on, among other things, the volume to be factored, the size of the invoices, the timing of the likely collections, and the industry in which the business operates).

A Merchant Cash Advance traditionally was structured as a contract between an MCA provider and a small- to medium-sized merchant[9] whose business accepted credit and debit cards. The MCA provider made an immediate cash advance to the merchant in return for a percentage of the merchant's future card receivables. Over time, the definition of what constitutes an MCA has broadened to include total revenue (that is, cash revenue, as well as card payments). In addition, payments on MCA contracts are now made by daily (or weekly) ACH[10] debits direct from the merchant's business bank account and often represent general cash flow advances. The industry is moving quickly, but the constant is that MCA involves the purchase of a ***future stream of revenue***.

Direct lending to both factoring and MCA companies can provide many benefits to an investor. However, the category is not without risk, so it is critical to understand the characteristics of these investments, especially their contract provisions. Diligently structured and attentively monitored, the risks can be managed, and these instruments can provide generous returns when compared to other yield-generating alternatives.

Compelling attributes of direct lending to factoring and MCA providers include:

1. High yields, ranging from high single digits to mid double digits;
2. Short duration - measured in months, not years;
3. Opportunity to participate in direct financing as a lender or co-lender to loan originators and/or as a loan originator;
4. The growth rate for factoring was 13% in the U.S. over the five years ending in 2013, and was much higher internationally; growth rates in the MCA industry over the past three years have been approximately 20%[11];

[9] The Small Business Administration defines a small business as any firm that employs fewer than 500 employees. However, the categorization as a small business by industry may also be constrained by maximum amount of revenue. Thus, a business can range in size from a maximum of $750,000 in annual sales in some industries to a maximum of $38.5 million in other industries. As a rule, the maximum is $7.5 million in annual revenue for most personal service industries. Source: U.S. Small Business Administration website.

[10] https://en.wikipedia.org/wiki/Automated_Clearing_House, Automated Clearing House (ACH) is an electronic network for financial transactions in the United States. ACH processes large volumes of credit and debit transactions. Its credit transfers include direct deposit, payroll, and vendor payments.

[11] https://localmarketingstars.com/s=Local+Marketing+Stars%27+Predictions+for+Merchant+Cash+Advance+Industry, Local Marketing Stars blog, undated.

5. There are few, if any, “pure plays” in the public equity marketplace, adding scarcity value.

In addition, investment in MCA specifically is buoyed by the following developments:

1. The MCA industry is maturing, that is, stronger organizations, including large, branded public companies, are now participating, bringing both capital and greater financial discipline, and
2. Legally, the conflict over whether an MCA contract is a “sale” or a “loan” is being defined in important jurisdictions, including New York. Depending on the provisions of the agreement, a properly-structured MCA can readily be considered a sale, although some New York trial courts have also found that certain MCA contracts can trigger criminal usury (lending money at an unreasonably high interest rate). Though the matter is by no means settled, the growing number of rulings that an MCA is a sale contract have the potential to reduce future lawsuits and regulatory attention.

An institutional investor cannot purchase a factoring or MCA contract on an exchange. Investors attracted by the positive attributes of these investments might participate in the following ways:

- Purchase the common stock of a company that derives a significant portion of its business from either factoring or MCA. Unfortunately, there are very few public companies that count factoring or MCA as a majority of their business. CIT Group, for example, does break out factoring as a separate business segment, but it is a small percentage of the company’s total revenue. On the MCA side, there are only a few public companies doing significant MCA business, frequently as part of a small business lending product line.

  A meaningful caveat to this approach: Why would an institutional investor, interested in the yield contribution and short duration of factoring and/or MCA contracts, purchase common stock, and incur the volatility of the stock market?

- Approach an organization that provides factoring or MCA services and ask how to participate in funding the contracts. Both factoring and MCA have the need for institutional investors to fund their businesses.

  Challenge: How does one identify the loan originators that adequately protect investors? How does an investor form a structure to lend to the factors and/or MCA providers that contains adequate investor protections? After all, the contract is written between the provider and the merchant with no real incentive to build in separate protections for the investors. If such a structure can be built, how does the investor evaluate its adequacy over time?

It is quite difficult for an investor to put together a start-to-finish loan originator. Given that, an investor might lend to one of these loan originators, whether a factor or MCA. In turn, the loan originator combines its funds with the investor's to purchase receivables (factor) or provide cash advances against future receivables (MCA). As a duty of care, we must first consider some of the pitfalls, the risks to such investor:

1. What are the terms of the contracts and how do those terms protect the investor? What covenants are required?
2. How current is the technology? Is the payment processing, data reporting, and management software up-to-date and integrated with the contract?[12]
3. How thorough is the merchant vetting process? What are the underwriting guidelines?
4. What if the merchant does not repay the MCA contract or undermines it in some way?[13]
5. What is the legal and regulatory environment?
6. What is the historical experience of the factor or MCA provider?

Considerable expertise is required to properly protect investors from these risks – legal acumen is necessary to ensure that contracts are well-drafted and a hands-on approach is required when vetting the merchant and setting up underwriting guidelines. Any hint of contract default requires that a structure be in place to identify and consider alternatives, such as a contract extension. The organization writing the contract must have a process in place to attend to each of the risks, approach them in a thorough and deliberate way, and relentlessly follow up to ensure that slippage, if any, is kept to a minimum. For example, requiring personal guarantees of the principals goes a long way toward reducing or eliminating slippage. Investors must be represented at every step of the way to ensure that not only are processes in place but also that everyone involved is doing what it was agreed he/she would do. We call these Investor Evaluation Touchstones (see Appendix 1).

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[12] http://www.wsj.com/articles/how-a-growth-push-derailed-can-capital-a-big-lender-to-small-businesses-1484587393, January 19, 2017, The Wall Street Journal, by Peter Rudegeair. CAN Capital Inc., one of the most successful and venerable of online small business lenders, had to cease making new loans in 2016 when it was discovered that its method of reporting client delinquencies was in violation of loan covenants with its investors and creditors. CAN's systems allowed employees to grant a few extra days to repay without any modification to the agreement. Had management insisted on integrating delinquency reporting with the loan covenants at the credit facility the breach might have been avoided. Although only 3% of loans were affected, members of top management were replaced and over 50% of its workforce was laid off. CAN Capital returned to the business in mid-2017.

[13] https://www.reuters.com/article/us-usa-onlinelending-stacking/latest-threat-to-online-lenders-stacking-of-multiple-loans-idUSKCN0YW0SV, June 10, 2016, Thomson Reuters, by Heather Somerville, Olivia Oran, Joy Wiltermuth. "Stacking" is the layering of multiple MCA contracts by the same merchant by different MCA providers, without the full story of his/her deteriorating ability to repay being made known to the original contract provider(s). Stacking undermines the basis on which the original contract(s) was/were written and increases the danger of default. Some MCA providers claim to have ways to guard against stacking, but the practice remains a risk to the industry.

After the contract has been signed and the parties have begun to execute on its terms, one touchstone is to monitor and track every process pertaining to the contract. This is more complex than it may seem as it involves the investor, the merchant, the factor or MCA provider, bankers, attorneys, and often multiple third-party firms. Further, the combination of business, legal, and investment skill required to properly ensure performance of these tasks is not acquired quickly.

We encourage any investor seriously considering direct participation in factoring or MCA to approach the area with eyes wide open, build as much distance from the risks as is consistent with reasonable yield goals, and leverage investment professionals who understand and are involved with the processes daily.

This research note will delve deeper into all of these issues, lay out several approaches for participation, and provide a due diligence check list.

I. GROWTH OF FACTORING AND MCA CONTRACTS

Factoring has been around for centuries, having risen to common use in medieval England and later brought to the American colonies.[14] Today, however, the best growth rates for factoring are found outside the United States. For the five years through 2013, the global factoring market grew at 24.8%, while U.S. factoring volume grew at 13.1%. China turned in an impressive five-year compound annual growth rate of 54% in factoring volume,[15] during the slowest economic recovery experienced in modern times. The increasing size and rapid growth rate of China's factoring portfolio has, of course, lowered the rest of the world's market share. However, despite retaining only around 8% of the global factoring market as of the end of 2013, factoring in the U.S. is a $240 billion business, not an insignificant number.

Global factoring volume was $3 trillion (yes, that's a "t") in 2013.[16] Asia represented $810 billion of that with 60% of Asia's number ($486 billion) from China alone. As mentioned, the U.S. had just 8% of the factoring market, down from an 11% share at the end of 2007.[17] Despite China's impressive growth, Europe continues to have a majority of global factoring volume, at $1.9 trillion. Around the world, there is a general acceptance of factoring as preferable to other forms of trade finance. Since 2013 the U.S. factoring market has flattened and China's stellar growth has softened along with their economy, although reliable global numbers are still incomplete.[18]

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[14] https://ecapital.com/the-history-of-factoring, The History of Factoring.
[15] www.ucfunding.com/world-factoring-industry-3-trillion-business, United Capital Funding Conference Report.
[16] Id.
[17] Id.
[18] http://fci.nl/en/about-factoring/statistics, This data is stated in euros with no indication as to what dollar/euro exchange rate was used.

A veritable infant by comparison, MCA contracts came into use in the late 1990s and, by 2004, the predecessor to CAN Capital[19] was writing MCA contracts at an intense pace. They had booked only $9 million in MCA in 1999 but reported $200 million in the category by 2006,[20] a seven-year compound annual growth rate in excess of 55%. Today, the total annual dollar amount of MCA contracts written is estimated to be $3 - $5 billion, primarily in the U.S.

The segment has a bright future. Three years ago, the industry could not boast a single public company. Square and OnDeck, to name two, have gone public within the past three years[21] and other branded names, such as PayPal and American Express, have dramatically grown their small business platforms, either through acquisition or as an extension of existing business. Quietly, Wells Fargo is funding CAN Capital's return to the lending marketplace.

The expected annual dollar amount of MCA contracts for 2017 is $15.3 billion,[22] up from $10.7 billion in 2015, although these numbers count specific small business loan activity as well as traditional MCA contracts. This estimate has grown so substantially from the $3 - $5 billion number mentioned above because, with larger and more sophisticated players involved, MCA now includes cash revenue as well as card receivables and includes general cash advances, not just the working capital boost the merchant receives from the sale of card receivables. Increasingly, MCA also includes certain loans – the point is that the definition of "MCA" has been rapidly expanding.

LendingClub, one of the larger companies involved in the business funding sector, believes its potential market opportunity in this sector (over multiple years) is in the $300 billion range.[23] Admittedly, this is their estimate of their total participation in business funding, including loans. It is interesting to note that LendingClub's target business owner has a minimum FICO score of 660! When the demand from lower-FICO score business owners is added to LendingClub's estimate of their higher-FICO score customers, the expected size of the market would become substantially larger.

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[19] CAN Capital exited the MCA business in late 2016 after its internal controls failed to protect investors. See: http://www.wsj.com/articles/how-a-growth-push-derailed-can-capital-a-big-lender-to-small-busineseses-1484587393, The Wall Street Journal, January 19, 2017, by Peter Rudegeair. CAN Capital returned to the MCA marketplace in mid-2017. See also Footnote 12.

[20] http://debanked.com/2013/01/before-it-was-mainstream, deBanked, January 24, 2013, by Sean Murray.

[21] Square exited the traditional MCA business in mid-2016 and transitioned to a bank partnership that makes term loans but with daily payments. Investors speculate that the move is a price/earnings (P/E) ratio play. Financial services companies sell at a 12 – 15 P/E ratio while technology companies can command much higher P/E ratios. By bundling and selling its existing loans Square exits a business segment that both ties up capital and holds down valuation. Square could then concentrate on its technology platform and simultaneously expand its P/E ratio. See http://debanked.com/2016/03/why-square-ditched-their-merchant-cash-advance-program, deBanked, March 27, 2016, by Sean Murray.

[22] https://localmarketingstars.com/s=Local+Marketing+Stars%27+Predictions+for+Merchant+Cash+Advance+Industry, Local Marketing Stars blog, undated.

[23] http://debanked.com/2014/08/are-we-in-a-300-billion-market, deBanked, August 7, 2014, by Sean Murray.

Factoring currently can offer annualized returns as high as 40% to the loan originator. The process is generally stable and well understood; in fact, banks frequently recommend factoring to their small business customers. As measured by the Annual Percentage Rate equivalent, MCA currently can also offer gross returns in the 40% range (and higher, depending on perceived risk) for the loan originator. Such attractive returns for two specialty finance products with short duration are exceedingly interesting investment ideas because the loan originator (factor or MCA) has enough yield room or spread to be able to pay its lender, i.e., the investor, a relative high rate.

Of course, the institutional investor lending money to these entities positions itself one layer away from the loan originator, and all parties require reasonable returns. Thus, an investor lending money to a loan originator can earn a high-single digit to mid-double digit yield, an excellent return for an investor seeking yield. Despite this positive trajectory, the risks are real, and require focus on contract drafting, the appropriate underwriting standards, and execution. However, the risk/reward ratio provides opportunity for the careful investor.

II. WHAT HAPPENED TO TRADITIONAL SMALL BUSINESS LENDING?

The banking industry reports that loans to large companies (loans greater than $1 million) are up 4% since 2011, when loan activity at U.S. banks bottomed out. However, bank loans to small companies (loans less than $1 million) are down 20% since their peak in 2008.[24]

The overall decline in bank lending to small business has been disappointing. The segment has been responsible for the creation of two out of every three net new jobs and consistently employs about half the private sector workforce.[25] Yet, during the recovery from the Great Recession, bank lenders pursued larger companies, those ready to borrow over $1 million, to the near exclusion of small- and medium-sized businesses.

In addition to compliance with the new post-Recession capital requirements and other regulations, banks continue to operate with a high cost structure and, in many cases, outdated technology. Small business lending is known to be riskier than lending to large businesses.[26] At the same time, the underwriting process is often as complex for a small company as it is for a large one due, in part, to a lack of homogeneity in the category. Banks quickly concluded that the cost of writing a $1 million loan was the same as the cost of writing a $100,000 loan.[27] Obviously, the larger loan is more profitable for the bank.[28]

[24] Small Business Lending: Credit Access, Mills and McCarthy, page 24.
[25] Small Business Lending: Credit Access, Mills and McCarthy, page 3
[26] Small Business Lending: Credit Access, Mills and McCarthy, page 6
[27] Id.
[28] Id.

Simultaneously, the Recession hammered small company sales and income[29] and the real estate many business owners had put up as collateral was now worth less. Thus, small businesses became less qualified for loans than they had been before the Recession. Community banks, which had traditionally served small business, became more focused on regulatory requirements and more risk averse. As regulators forced banks to meet stricter capital requirements, riskier loans, such as those to small businesses, just weren't being made.[30]

Finally, bank consolidations, already underway prior to 2008, reduced the overall number of community banks.[31] This trend has continued, and during 2016, the FDIC (Federal Deposit Insurance Corporation) reports that there were no net new charters for banks granted in the U.S.[32]

It is not surprising then, that over the past two decades small business loans have declined from about half the total bank loan portfolio to 30%.[33]

III. THE BANK TERM LOAN OR LINE OF CREDIT – IF YOU CAN GET THEM

When working capital was subject to fluctuations, the business owner's banker would often suggest a term loan or working capital loan. In fact, the most common loan was a business line of credit (LOC), which, like a credit card, has a maximum limit and usually offers the ability to constantly borrow and repay any amount under that limit.[34] The bank term loan came at the cost of a personal guarantee and low credit scores did not qualify for either the loan or the line of credit. Furthermore, obtaining either was made even more difficult if business results were subpar.[35]

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[29] Small Business Lending: Credit Access, Mills and McCarthy, page 5.
[30] Id.
[31] https://www5.fdic.gov/hsob/HSOBRpt.asp, The FDIC table of Changes in the Number of FDIC-Insured Commercial Banks in the U.S. through 2016 shows that the number of banks peaked at 14,000 in 1985. In 2016, the total number of banks was 5,116. Unassisted mergers continue to average just over 200 per year in the nine years beginning 2008 through 2016.
[32] Id. There were also no net new bank charters granted in 2011, 2012 and 2014. Things have improved a bit in 2017. Bloomberg reports that, by mid-2017, six banks had either opened or been approved by the FDIC. https://www.bloomberg.com/news/articles/2017-08-31/rules-relax-rates-rise-and-some-new-banks-start-up-in-the-u-s.
[33] Small Business Lending: Credit Access, Mills and McCarthy, page 25.
[34] https://www.unitedcapitalsource.com/blog/difference-between-business-line-of-credit-and-a-working-capital-loan, What's the Difference Between Business Line of Credit and a Working Capital Loan, United Capital Source, by Jared Weitz, 2017.
[35] For longer term capital, such as fulfilling expansion plans or pursuing business opportunities, the banker might suggest a term loan. Such loans, however, require the business owner to meet even more onerous underwriting requirements. Still, in the category of bank loans, a term loan is the cheapest financing alternative available to a small business with good credit.

In addition to focusing on the regulatory environment, bank lenders, especially at larger institutions, have become more transaction oriented and less relationship driven. Small business owners no longer feel they have a partner at their local bank and are frustrated with the red tape and time required to get a loan approved.[36] At the same time, the speed at which businesses must operate to be competitive has accelerated. Small business owners are increasingly comfortable accessing information on a computer (or a mobile device) and often use such technology to run their businesses. Waiting weeks or months for loan approval does not fit the current pace of small business at all.

IV. SPECIALTY FINANCE PICKS UP THE SLACK

Given that small business owners believe banks underserve and undervalue them, it makes sense that hundreds of alternative lenders have arisen to augment the resources of existing loan originators. Many of these new entrants take applications electronically, have data-driven technology platforms with tools for evaluating applications, make decisions in a short time, and fund quickly. For small business, this means that the alternative lenders can advance cash flow, enhance working capital, or fund the ability to capitalize on a growth opportunity[37] within days or even hours. Although this sounds wonderful for the small business, some of the algorithms used to measure creditworthiness were not proven, contributing to higher levels of risk for the debt providers.

V. FACTORING

For a business without the credit rating to obtain a term loan or LOC, factoring can be the right solution. It can smooth cash flow in a seasonal business and provide money for a rapidly growing one.The business owner also may use the factor's collection capability, reducing or eliminating owner collection costs.

The process of factoring entails selling a portion (or all) of a business' existing accounts receivable, as evidenced by invoices, to the factoring company in return for a "factoring advance," usually around 70% - 85% of the total receivables factored. The factor then owns the receivables and collects the payments directly from the customers. Occasionally, the business owner can select which accounts to factor, but most often this decision will be made by the factor.

Assume the factoring advance, or "advance rate," is 80%. Upon the presentation of valid invoices, the factor pays, or advances, the merchant/client 80% of the value of the invoices factored, which the merchant can then use to run his or her business. If all customers pay their invoices in full, the factor takes its fee from the 20% it retained and returns the remainder to

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[36] Small Business Lending: Credit Access, Mills and McCarthy, pages 17 – 27.

[37] https://www.square1bank.com/borrow/specialty-finance, Specialty Finance – Square 1.

the business. If the factor must expend resources to collect the receivables, it deducts those costs, which reduces the amount returned to the business. The factoring contract may allow the factor full recourse to the business; that is, if the customer doesn't pay the factor, the factor can demand that the advance be repaid from the client's other business assets.

For many businesses factoring is an ongoing process.[38] Immediately turning invoices over to the factor generates instant working capital for the business owner. For others, it can be a seasonal process; e.g., the factor provides capital allowing the merchant to stock adequate merchandise in advance of the December holidays. Consistently turning the invoices of dependable clients over to a factor for collection can also be expected to earn cost discounts for the merchant as time goes on.[39] For example, incidental fees may be waived or, more importantly, as the factor's confidence in the dependability of the relationship increases, the factor rate could decline.

What determines the factor rate?[40] Items that impact the rate include:

- Monthly factored volume and average invoice amount. A high volume of factored invoices, consistent or growing month after month, earns the merchant a lower rate over time. Similarly, high-dollar-amount invoices also lower the factor rate. Since collection is a labor-intensive process, factoring one $50,000 invoice rather than fifty $1,000 invoices improves the terms.
- Client creditworthiness. Prior repayment experience the merchant and the factor have had with an invoiced client will have some effect on the factor rate. The creditworthiness of a particular account receivable is also used to determine whether the invoice will be accepted for factoring at all. A factor is not a collection agency and will turn down invoices that are aged or have a history of late or non-payment.
- The industry. Industries deemed to be lower risk, such as consulting, staffing or transportation, pay lower rates. High risk industries, such as construction, pay higher rates.
- Business characteristics. Businesses that are stable and have consistent histories and capable management will pay lower factor rates. New companies or those with less stable histories will pay higher rates.[41]

Factor rates can range from 1.5% to 5.0% per 30-day period. In the current environment, factor rates average 3.5%, with higher risk clients paying the higher rates. A 30-day agreement for a given set of receivables generally means that the factor expects that the receivables factored will all be collected within 30 days. If the factor generates a factoring contract for $10,000 every 30 days at an 80% advance rate for a year, the gross return to the factor will be 52.5% ($350/$8,000 x 12 months). Some factoring contracts are written for 45 days (or other

[38] https://www.comcapfactoring.com/blog/average-factoring-costs, Typical Factoring Rates.
[39] Id.
[40] Id.
[41] Id.

periods). Using the same numbers and the same factoring rate of 3.5%, a 45-day contract could turn over eight times per year (360 divided by 45), generating gross revenue of 35% ($350/$8,000) x 8 .

A factoring client may have reasons for entering only into a one-time, short-term factoring arrangement. This is known as spot factoring and may come at a higher cost. In any event, from the factor's viewpoint, the best factoring arrangement is one where the business owner signs a contract for at least a year, uses the factor's collection mechanism, routinely turns high quality invoices over to the factor, and integrates factoring into his or her business processes.

A. FACTORING CONTRACT – EXAMPLE

Factoring fees are varied and often complex. No two factors are alike in terms of the fees they charge or how they are calculated. However, the basic factoring fee falls into one of three categories: flat fees, tiered fees, or prime plus fees.

To illustrate how a flat fee arrangement[42] works, assume that the factor has evaluated the merchant's factor volume, size of each invoice, and history of the business. The merchant has chosen $400,000 in receivables to factor, consisting of eight invoices of $50,000 each. In this case, we will assume a higher quality factoring arrangement than the previous example of 3.5%, that is, 2.5% for 30 days.

Flat fee terms: 80% advance at a factoring fee of 2.5% per 30 days

Advance Rate: 80%	Percent of total invoice amounts paid immediately to company by factor in return for the sale of receivables
Advance Amount: $320,000	(0.80 x $400,000) dollar amount of immediate advance paid to merchant
Reserve Amount: $80,000	(0.20 x $400,000) dollar amount reserved by the factor for late payments, other expenses, etc.
Discount Rate: 2.5%	Percentage of total invoice amounts factor charges as its fee

Assume that all factored invoices are collected within the 30-day period. The factor keeps $10,000 (0.025 x $400,000) as its fee and returns the remaining $70,000 ($80,000 originally withheld, less the factor's $10,000 fee) to the merchant.

[42] https://www.merchantmaverick.com/understanding-invoice-factoring-rates-fees, Posted to Merchant Maverick website, dated May 11, 2017, by Blanca Crouse.

Alternatively, instead of all invoices being collected in the 30-day period, assume that the invoices are 75% collected (or $300,000) within 30 days but the remaining 25% ($100,000) are not collected for 60 days.

Actual Results	75% collected within 30 days; 25% collected in 60 days
Rate on Payment after 30 days	0.1% per day or 3.00% per month

The factor collects an additional three percentage points on $100,000 from day 31 through day 60. The factor earns $10,000 on the entire $400,000 for the first 30 days (0.025 x $400,000) plus 3% for the additional 30 days it took two of the customers to pay (0.03 x $100,000). Thus, the factor collects a total of $10,000 + $3,000 = $13,000. The factor returns $67,000 from the $80,000 reserve amount to the merchant ($80,000 - $13,000).

A tiered fee arrangement[43] occurs when a factor charges a fee for each day that each invoice is outstanding. Assume $400,000 in invoices, consisting of eight invoices at $50,000 each and the payment schedule detailed below. The amount that is being charged by the factor in this tiered fee contract is 1.8% per month. For simplicity, assume that the invoices are paid on the 10th day of the increment shown.

Tiered fee terms: 80% advance at a factoring fee of 1.8% per month

Tiered Fee Factoring Arrangement

Days	***Daily Factor Charge (1.8% Monthly Rate)***	***Invoices Paid***	***Remaining Invoices***
			$400,000
0 - 10	$2,400	$50,000	350,000
11 - 20	2,100	50,000	300,000
21 - 30	1,800	50,000	250,000
31 - 40	1,500	0	250,000
41 - 50	1,500	50,000	200,000
51 - 60	1,200	100,000	100,000
61 - 70	600	0	100,000
71 - 80	600	50,000	50,000
81 - 90	300	50,000	0
Total	$12,000		

[43] Id.

If the same rate (1.8% per month) had been charged in a flat fee arrangement, the fee for the entire month would have been taken at the beginning of the month, no matter when invoices were paid. The fee would have been calculated as follows:

Days	***Flat Fee Factoring 1.8% Per Month***	***Invoices Paid***	***Remaining Invoices***
			$400,000
1 - 30	$7,200	$150,000	250,000
31 - 60	4,500	150,000	100,000
61 - 90	1,800	100,000	0
Total	$13,500		

Under this arrangement, the total cost to the merchant would have been $13,500, because the flat fee methodology does not allow for the fact that several of the invoices were paid in the middle of the period. In the tiered fee arrangement, the fee is charged only through the day payment is actually received. In general, the earlier the invoices are paid, the lower the tiered fee.

The factoring company may use still another method to calculate fees, the Prime Plus method.[44] Prime Plus charges a basic factor rate plus interest *only on the amount advanced*, which in this example, is $320,000. Assume that the contract states that the interest charge will be prime rate plus two percentage points, and that the current prime rate is 3.75%, which results in a Prime Plus rate of 5.75%. Assume the amount borrowed is $320,000 and that 75% of the receivables were collected over a 30-day period, with an average collection period of 15 days. The interest charge for 15 days is 5.75% divided by 12 months, divided by ½ month, or 0.24%. When applied to the 75% of invoices repaid ($320,000 times 75% = $240,000) the resultant interest charge is $576 ($240,000 times 0.0024). The remaining 25% of receivables ($80,000) was not paid until the very end of the 60-day period, so the applicable interest rate is 5.75% divided by 12 months times two months, or 0.96%. $80,000 times 0.96% = $768. Therefore, the total interest paid to the factor on the amount borrowed is $576 plus $768 = $1,344.

Assuming the original factoring fee of 2.5% for 30 days, the merchant pays $10,000 in factoring costs. And given the delay in collection of an additional 30 days, either $3,000 in additional collection cost, as shown in the 3% per month additional collection fee example above, or $1,344 in interest on the amount loaned, as in the case of the Prime Plus method.

The tiered fee method charges for every day an invoice is outstanding, so it has no need for a "late payment" provision. On the other hand, the flat fee method, usually written for a 30 or 45-day period, will typically have either a late fee provision or will reflect the cost of late payments with interest collection (Prime Plus).

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[44] Id.

The merchant may also pay additional fees, depending on the terms of the contract. For example, there may be a one-time set-up fee. There will also be an additional fee if the merchant insists that the factor have no recourse back to the business if some customers do not pay their receivable. Some factors add still other fees, such as wire fees or processing fees. The contract might also specify that the merchant must retain the factoring company for at least a year or pay a termination fee.

It is impossible to list all the combinations of factor fees, late payment fees, and interest costs currently in use by factoring companies. It is, however, important to understand that the factoring company will use combined fees to ensure its continued profitability.

B. DILUTION[45]

One of the major risks with which a factor is confronted is "dilution." Dilution is the historical percentage collected on invoices versus the amount billed. For example, if a client bills his or her customer $1,000 but the customer only pays $950, the 5% difference, or $50, is the dilution to the receivable that was billed. Dilution arises in an account receivable when the customer, or account debtor, issues credit memoranda for returned goods that did not meet specifications or didn't sell through. Dilution also occurs when the account debtor takes an offset for advertising and marketing allowances that were not disclosed to the factor.

Dilution is critically important to the factor because it directly affects the ability to be fully repaid on advances made on a group of accounts receivable. If a factor advances 80% of the value of an invoice and the dilution turns out to be 30% (70% of invoice paid), the factor has made an advance that exceeds the value of the collateral.

Dilution is one component used in determining the advance rate. Thus, determining historical and projected dilution rates is critical. This determination can be guided by the borrower's past experience subject to verification, industry norms for specific account debtors (the party paying the receivable), and the type of good or service rendered by the borrower. Potential dilution is one of the variables to be used by the factor to decide the relevant advance rate. Others include receivable concentration, defaults, turnover rate, and cross-aging.

C. FACTORING PARTICIPATIONS

Most often, larger factors have a senior bank lender already in place and, while it may not eliminate the opportunity for the alternative lender, it can change the structure. Some alternative lenders would elect to be subordinated to the senior lender. Alternatively, there usually will be concentration limits established by the senior lender regarding how much can be advanced against a single account obligor's receivables, opening the door for others. This

[45] http://www.fastarfunding.com/blog-factoring/bid/52345/Factoring-Receivable-Financing-Dilution-Meaning-Part-1.

situation creates an interesting nexus for everyone's interests to be aligned. To wit, the factor does not want to lose a big account because of the lower limit, which would also alienate the factoring client; the bank does not want concentrated risk; and the alternative secondary lender wants to participate. In this case, the financing of the account is jointly participated in by the bank and the alternative lender, usually on a pari passu basis. Yet, the alternative lender can negotiate an attractive yield, higher than the bank, but at a greater cost to the factor because, through the participation, the factor can earn their higher fee on the non-participated piece, still retain the client, and earn on the participated piece as well, albeit at a reduced rate. Typically, the secondary lender in these situations will receive 80% of the factor's gross interest rate charged to the borrower.

VI. THE MERCHANT CASH ADVANCE (MCA)

As knowledge of the MCA space has expanded and the economic recovery has gained more steam, some of the risk has gone out of these contracts and APR equivalents have declined to the still-lofty present expectation of 35% – 50% to the MCA provider. For riskier contracts, APR equivalents may still be in the 70% – 90% range in some jurisdictions but higher quality merchant contracts will center in the 45% range. With these rates, an MCA contract may seem like a superb investment. Potentially, it is. However, as we discuss below, an APR equivalent for an MCA may not be directly comparable to that of a fully amortizing term loan. If a term loan has an APR of 10% or so, the higher APR equivalents for an MCA represent compensation to the provider for the extra risk that MCA's carry. For example, many small businesses utilize MCAs as their only source of financing.[46] Owners of such businesses may have lower credit scores or limited credit histories, or may be in the start-up phase of their businesses. The MCA contract provider expects to be compensated for these incremental risks.

Businesses that utilize MCAs include restaurants, salons, independent garages, gymnasiums, and many other independent retailers or service providers. Because many MCA providers are making decisions based on rapidly available electronic data (e.g., credit scores, card sales history, bank statements, tax returns), the money is generally available to the merchant within a few days. Thus, for these busy entrepreneurs the MCA is much easier to obtain than a bank loan.

A. MCA CONTRACT – EXAMPLE[47]

A merchant decides that he/she needs $50,000 and wants to use an MCA contract. The documentation (tax returns, evidence of card sales, etc., as mentioned above) is scanned to the MCA provider who runs the application through its electronic decision-making software.

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[46] See generally the story of Holly Rooney from Section 1.A of Article: The Merchant Cash Advance Industry May Have a Few Bad Apples But That Does Not Mean It's Time to Empty the Barrel: Comment, 49 Texas Tech Law Review 501, by Jordan Stevens.

[47] Many vendors provide MCA calculators. This one is from https://www.fundera.com/resources/apr-calculators/merchant-cash-advance-calculator.

To understand the MCA transaction, we present an example with the following assumptions:

Amount Advanced to Merchant	$50,000
Monthly Credit Card Sales	$36,000
Credit Card Sales Purchased	14%
Origination Fee	$0
Factor Rate (or Buy Rate)	1.25

The merchant wants a $50,000 advance and monthly card sales average $36,000. The MCA provider determines an appropriate "factor rate," (aka, "buy rate"), usually a number between 1.1 and 1.5,[48] of 1.25, which reflects an assessment of the transaction risk. (A higher factor rate, say 1.5, would indicate a higher level of risk).

Using the data provided, we can calculate the factor rate as follows:

Approximate Daily Payment	$168	0.14 x ($36,000 ÷ 30)
Approximate Repayment Period	372 days	$62,500 ÷ $168
Equivalent Annual Percentage Rate	45.4%	NPV= ∑(Cash Flow/(1+r)^{t})-Initial Investment
Total Factor Rate Cost	$12,500	0.25 x $50,000
Total Cost of Contract	$62,500	$50,000 + $12,500
Factor Rate	1.25	$62,500 ÷ $50,000

The merchant remits $62,500. Dividing $62,500 by the $50,000 advance = 1.25, the factor rate. The MCA provider earns a gross return on the contract of $12,500. It is unfortunate that both factoring and MCA's use the term "factor" as part of their terminology. There is ***no*** connection between a factoring rate as used in factoring, and the factor rate, or buy rate, used in the MCA business. In factoring the factoring rate is part of the compensation to the factor for collecting the invoices. MCA's factor rate is a calculation of the total amount the merchant will need to remit on the contract out of future revenue.

The MCA factor rate is <u>not</u> considered an interest rate because the MCA contract is not considered a loan. It is merely a way to understand the total amount the business owner will need to pay back to the MCA provider. In this case, one would first multiply the factor rate by the amount borrowed. (1.25 times the advance amount of $50,000 = $62,500). While one is tempted to say that the interest rate is 25%, that is not the case. The 25% is the money cost of the advance. All the cost is charged to principal when the cash advance is originated. This is very different from interest charged on a fully amortizing term loan which would show an interest charge on an ever-declining principal balance. Thus, the MCA contract is not stated in terms of an Annual Percentage Rate (APR) as is a term loan.

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[48] Fundera Ledger, What is a Factor Rate?, December 14, 2016.

The MCA provider is purchasing 14% of future card sales and, for simplicity, we assume there are no fees. The merchant will pay 14% of daily collections on the MCA contract. Assuming a 30-day month, 0.14 x ($36,000 ÷ 30) = $168 on average per day.

To repay $62,500 at an average rate of $168 per day will require 372 days of payments, or just over one year. The merchant or its payment processor will deduct 14% of the merchant's daily card collections and remit them to the MCA provider for 372 days. Because the payment is based on a percentage of card sales, the merchant pays less when collections are down and more when collections are higher. However, if collections stay low for a long period of time, the contract could extend beyond its original 372-day term to expected completion.

Let's assume that average monthly card sales decline from $36,000 to $30,000 and stay that way. This lowers the daily payment from $168 per day to $140 per day. Instead of being paid over the estimated 372 days, the contract now will be repaid in 447 days. Thus, the contract has extended from approximately 12 months to almost 15 months. The MCA provider has put $50,000 into the deal, not counting expenses, with the expectation that payback would occur in 12 months. Now it will require nearly 12 months (357 days) just to break even. The provider's expected APR equivalent on the contract has gone from 45% to 38% in this scenario.

If the merchant goes bankrupt in that year, the MCA provider has limited to no recourse to the assets of the business – otherwise, it could be construed as a loan and become subject to the state's usury laws. Although recourse may be negotiated in some cases, the provider's main protections are the underwriting standards, the contract terms, and the cash controls built into the deal. Referring to our Evaluation Touchstones (Appendix 1), the alternative lender could insist on a provision for a cash control agreement in the event of bankruptcy. The risk of fraud can be handled in part with a personal guarantee, structured as an "indemnity guarantee." These and other investor protections might be executed in such a way that the contract would not be considered a loan.

The cost of the contract is added to the balance at the start of the contract (rather than amortized and applied to an ever-declining principal balance, as is the case with a loan). The Annual Percentage Rate equivalent is 45%. It's important to note that turning a Factor Rate into the calculation of an equivalent Annual Percentage Rate is not really, well, "equivalent." An APR is a useful calculation on a loan that requires the borrower to meet a fixed schedule of repayment. Importantly, if the borrower goes bankrupt, the lender may have recourse against the borrower's assets. An MCA provider, as originator, buys a stream of future revenue (usually card receivables) and collects those daily. If the merchant goes out of business and the payment stream stops, there is limited to no recourse to the merchant. The payment stream slows or, in some cases, just goes away.

B. STACKING

An all-too-common problem in the MCA industry is a practice called "stacking." Merchants may find that the daily payment of 10% or 12% of their credit card collections or bank account debits

to the MCA provider is too difficult for them. To gain relief from the burden, a merchant will execute a second MCA contract with a different firm and use the proceeds from the second MCA to, in part, replace the lost cash flow from the first MCA. Thus, a second MCA is "stacked" onto the first. Sometimes, a third is stacked onto the other two, and so on.

Repeated stacking potentially creates a debt spiral from which the business may never recover. Unfortunately, multiple MCA contracts are frequently not revealed by the merchant until the debt problem becomes too dire to ignore. Business owners who didn't comprehend the consequences of stacking have ended up in bankruptcy court and their MCA providers have experienced less than optimal returns on their investment.

Exercising moral suasion on the MCA industry doesn't appear to have fixed the problem. Neither has a "gentleman's agreement" among MCA providers that attempted to stop the practice. Software companies have claimed that their "superior" software can prevent stacking. Whatever the attributes of a company's wonderful new software innovations, stacking appears to be continuing anyway.

To eliminate or limit the potential for stacking, it is critical that some of the Evaluation Touchstones are implemented. There is no substitute for getting to know the merchant. Such matters as compliance with laws, solvency, and prior litigation should be a routine part of the lender's investigative process. One particularly useful practice is to ensure that the merchant, at the time the contract is executed, represents that he/she has revealed all existing MCA contracts (and similar arrangements, if any) and will undertake to keep all parties updated on any layering of additional debt that occurs in the future. Violating this representation can result in additional liability against the merchant that otherwise would not have allowed recourse for the MCA. While this won't stop outright fraud, a merchant may think twice once the dangers of stacking are brought to his/her attention.

C. MCA – THE FUTURE

As numbers like $400 billion of unmet small business financing demand (over multiple years) are bandied about, it is important to note that the $400 billion represents a combination of lending as well as traditional MCA. Considering just MCA, industry observers believe there is $80 billion to $120 billion of unmet MCA funding, spread over multiple years, among the 5.7 million small businesses in the U.S.[49]

Over time, MCA providers have developed technology that includes databases with improved data quality. These have, in turn, contributed to lower risk and better rates. While this has lowered the cost of the transaction for the business owner, it has also lowered the return to the

[49] Op cit. Local Marketing Stars blog, undated. The blog notes that there are 5.7 million small businesses in the United States. Actually, the SBA reports that there are 28.7 million small businesses in the U.S. However, 23 million of these are either home-based entities or sole proprietorships, leaving 5.7 million that have employees and could need funding at some point. See also Mills and McCarthy, page 3.

MCA provider from APR equivalents unsustainably above 100% to a range of 35% – 50%, still quite a handsome return.

TABLE 1. COMPARISON – FACTORING VS. MCA

TOPIC	***FACTORING***	***MERCHANT CASH ADVANCE***
Industry Growth Rate	Stable, predictable, well-understood business; 13% growth rate in U.S.; much higher internationally; export factoring and trade finance look interesting	15% – 20% growth rate in U.S.; historically, product not well-known or well-understood; MCA has had boom/bust cycles
How Does it Work?	The factor buys a merchant's *existing invoices*, providing immediate cash to the merchant in return for a percentage of those invoices. The merchant then collects the invoices and retains a fee.	MCA provider agrees to advance a sum of money to a business owner and in return the merchant agrees to sell the provider a percentage of its *future expected revenues* to be collected daily until the amount advanced is repaid.
Return to Loan Originator	Typical returns will annualize in a range from 28% – 42%; niches and international returns higher	APR equivalent returns in the 35% - 50% range; riskier contracts in some places are still in the 70% – 90% range
Competition	Encroachment recently from online lenders and MCA vendors	Large branded companies and alternative lenders are now entering the business but have not met all small business need for capital
Duration	Short but dependent on invoice payment	3 – 15 months
Collateral	The subject invoices are purchased by the factor; invoices collateralize the advance	Some contracts remain unsecured and no collateral is required. Many now negotiate some collateral.
Contract Size	Accommodates contracts of $5 million and even higher	Contracts not usually larger than $250,000
Debt	Not debt – does not appear on owner's credit report	Properly structured, MCA is a sale, not a loan; does not appear on owner's credit report
Regulation	No direct government regulation; International Factoring Association is professional group	Limited federal regulation; no professional group at present; Uniform Commercial Code of each state governs the sales contract. Some courts have made attempts to turn MCAs into loans.
How to Participate	Many financial services companies have invoice funding divisions but few pure plays. Many factoring companies offer participation.	MCAs difficult to buy – no pure play public companies. Funding partners can be found but a fund with participation is a good choice (scarcity value?)

Advantages	Full recourse contracts ensure that the factor can go back to the owner to repay the advance, if client doesn't pay	Industry is maturing; stronger players bring capital and discipline
Disadvantages	Notifying account receivable obligors (purchasers of merchant goods or services, i.e., clients) to deal with the factor has a stigma attached to it in some industries. Invoice "dilution" can negatively affect collections and lead to a lower advance rate	Transaction is a sales contract, not a loan – no required monthly payment, no interest, no payoff requirement The "stacking" of multiple contracts can create a debt spiral for the business
Treatment in Merchant Bankruptcy	Recourse to the merchant is written into most contracts if account debtor doesn't pay; if merchant goes bankrupt, the factor owns the receivables and still collects	Contract extensions or restructuring aid a troubled merchant but MCA provider often has limited recourse to the assets of the business

VII. THE STATE OF REGULATION

Both factoring and MCA are viewed as alternative financing vehicles and neither is subject to either banking or securities regulations. Although writers in the field regularly predict that an onslaught of federal regulation is likely to be coming any minute, thus far little interest has been shown by regulators. As long as factoring and MCA transactions meet all the requirements of being a sale contract and not a loan agreement, both seem able to avoid becoming subject to banking regulations. In most jurisdictions, cases involving disputes between parties to either a factoring or MCA contract are governed by local Civil Code and/or the jurisdiction's version of the Uniform Commercial Code (UCC). Larger states have created their own regulatory bodies. For example, California's Department of Business Oversight oversees financial institutions and many financial services industry professionals.

A. FACTORING AND THE LAW

No comprehensive treatise on factoring in the United States even existed until December 2009, when *American Factoring Law* was published. Once released, this long-delayed publication began to guide contract drafting, provide definitions for arcane factoring terms, and explain operational procedures. The volume has become not only a textbook for those drafting factoring agreements but also a reference for casework in the court system. Since it was so recently (in legal time) published, we are just now seeing it cited, primarily in bankruptcy cases.[50]

A properly drafted factoring contract must ensure that the transaction actually is a sale and cannot be construed by its terms to be a secured loan agreement. Such provisions as security

[50] https://www.buchalter.com/wp-content/uploads/2011/10/American-Factoring-Law.ABIJournal.Rose_.pdf.

interests in accounts, the subordination of other debts, and substantial recourse against the owner in the event of client default are often deemed to evidence intent by the factoring company to convert the agreement to a secured loan. In such a case, there would be no transfer of ownership in the accounts receivable, something that is critical to the finding of a sale. Hence, factoring cases that result in litigation often turn on whether the contract involves a "true sale" or a loan agreement.

In February 2017, there was an interesting but confusing case in the Ninth Circuit of California involving the factoring of accounts receivable by Growers v. Tanimura Distributing, and Agricap Financial.[51] The Ninth Circuit's precedent for what constitutes a "true sale" was different from the test maintained by the Second, Fourth and Fifth Circuit Courts and the Ninth set out to eliminate this "circuit split" by finding that a transfer-of-risk test <u>is</u> the appropriate test for a true sale in the Ninth Circuit. To do this, the Ninth Circuit determined that a precedent case had been wrongly decided. The case becomes confusing because the Court never needed to find a true sale using the transfer-of-risk test since the assets were held in trust and there was no breach of trust. Further, the factoring agreement was commercially reasonable and largely executory anyway. The issue of what constituted a "true sale" never came up, despite the Ninth Circuit's finding that transfer-of-risk was the right test.[52]

There is likely more to come in the Ninth Circuit, but the point is that the tension between contract terms protecting the factor from default and the need for factoring agreements to contain the provisions necessary for a completed sale require a careful balancing of interests. They also require constant vigilance by all parties during the drafting process.

Recourse, notification, and several other provisions also require careful document preparation. A well-drafted factoring agreement must provide protections to multiple parties – the factor, the business owner, the investors, and the bank that is collecting interest or sometimes funding the transaction. These parties should be represented by attorneys who are totally involved in the contract negotiations. Keeping all attorneys up to date and participating in the drafting process will go a long way to ensure that, for example, a change in one provision does not alter the rights and responsibilities of others, as was the case with CAN Capital (see Footnote 4).

B. MCA CONTRACTS AND THE LAW

From a regulatory standpoint, the MCA contract has been difficult to characterize as either a sale or a loan. It doesn't appear to meet the requirement of a loan: no transfer of ownership to property, no fixed payment period, no interest rate, and no real obligation to pay off the agreed-upon amount. Since it does not have the characteristics of a loan, it is not governed by banking regulations as promulgated by the Federal Reserve Board and the U.S. Congress. The Consumer Financial Protection Bureau (CFPB), created in 2010 by the Dodd-Frank law, has been

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[51] http://cdn.ca9.uscourts.gov/datastore/opinions/2017/02/27/14-56059.pdf.
[52] Id.

actively enforcing rules to prevent "unfair, deceptive or abusive acts or practices (UDAPP)."[53] Because its mandate is fairness in *consumer* transactions, the CFPB has shown little interest in pursuing alleged abusive practices with business contracts. However, because of its aggressive pursuit of "bad actors" in the consumer arena and the fact that many small businesses are sole proprietorships and similar to individual consumers, the CFPB's actions are always watched with interest by the alternative lending industry.

In the absence of a clear federal nominee to provide oversight, MCA purchase/sale contracts are governed by the Uniform Commercial Code[54] from which each state derives its own rules for commercial transactions. A party to an MCA contract who believes he/she has been aggrieved has the option of taking the other party to court to enforce that state's interpretation of the contract. Historically, sloppy legal drafting and equally sloppy marketing material on the part of many MCA providers have made it relatively easy for such lawsuits to move forward. Decisions in some jurisdictions chipped away at the "contract" definition of the MCA and sought ways to interpret the contracts as loans. Finding that a loan existed instead of an enforceable commercial contract would then invalidate the contract as it would be in violation of the jurisdiction's usury laws.[55]

In March 2017, the Supreme Court of New York, Nassau County, clarified the difference between an MCA contract and an installment loan with its decision in *IBIS Capital Group, LLC vs. Four Paws Orlando LLC*, in the following decision:

"For a true loan it is essential to provide for repayment absolutely and at all events … (in contrast where) payment or enforcement (of an MCA) rests upon a contingency, the (MCA) agreement is valid even though it provides for a return in excess of the legal rate of interest."[56] In finding against the existence of a usurious loan in a precedent case, the court observed that 'the plaintiff assumed the risk that, if the receipts were less than anticipated, the period of repayment would be correspondingly longer, and the investment would yield a correspondingly lower annual return.'[57]

The court additionally noted language from the contract that set out the fact that IBIS would receive a percentage of Four Paws' daily sales and concluded that the transaction was not a loan. It also observed that the agreement had no due date, also a key factor in declining to categorize the contract as a loan.[58]

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[53] The Merchant Cash Advance Industry May Have a Few Bad Apples, Jordan Stevens, Section 2A.
[54] In general, the Uniform Commercial Code does not govern loans.
[55] A New York case reported out in October 2016, Pearl Capital Rivis Ventures, LLC v. RDN Construction Inc., had a sale contract that contained no language that the sale was without recourse to the merchant. Thus, the court found that the merchant was obligated to repay, that the transaction amounted to a loan with a usurious interest rate of 180% APR, and that the contract was invalid.
[56] Alternative Lending Report, April 20, 2017, Recent Litigation Illustrates Why Merchant Cash Advances Are Not Loans, by Mark Dabertin as reprinted by Pepper Hamilton LLP, Attorneys at Law, the Power of Intelligence, Insight Center: Publications.
[57] Id.
[58] Id.

In May 2017, *Colonial Funding Network Inc. vs. Epazz*, the U.S. District Court for the Southern District of New York dismissed counterclaims alleging that charging an excessive interest rate constituted usury and upheld the contract. This was the first federal case to find that an MCA contract does not create a loan.[59]

The *Colonial* decision also noted several provisions in the contract that are either not fatal to the finding of a valid agreement or which represent much needed guidance on structuring a legally enforceable MCA contract. For example, the court noted that the right to require reconciliation belonged to the merchant and that if the merchant failed to provide a bank statement to the MCA provider, the provider had the right to presume that the daily withdrawals equaled the 15% of daily receivables that had been agreed upon.[60] In addition, the *Colonial* decision noted that a personal guarantee would not render an otherwise bona fide MCA contract a usurious loan as long as the terms of the guarantee mirrored the obligations of the merchant.[61]

The MCA industry has generally applauded the recent findings of courts in several jurisdictions that properly constructed MCA contracts create a sale transaction between the parties and that, despite high interest rate equivalents, such contracts do not constitute a usurious loan. As a federal court, the *Colonial* decision sets a precedent for all federal cases, particularly since it was decided in New York, a jurisdiction with many thousands of businesses and an active commercial law practice.

C. THE SITUATION IN CALIFORNIA

MCA providers in California were not so quick to applaud. A class action lawsuit in 2004, *Bistro Executive, Inc. vs. Rewards Network, Inc*., was brought by 3,000 California restaurant owners against a dining rewards company which had made cash advances to the restaurant owners in return for as much as 200% of the originally advanced amount. The owners asserted that Rewards Network was engaged in a “loansharking scheme” that violated both usury laws and the California Unfair Business Practices Act.[62]

Although Rewards Network asserted that its contracts were not loans, it had, unfortunately, referred to them as loans in previous cases. Hence, the court found that Rewards Network could no longer make the argument that their arrangements were not loans. The court also noted that the agreements were not complete until the restaurant owners had repaid the entire purchase price to Rewards Network. Thus, there was an absolute obligation on the part of the restaurant owners to repay. Further, the restaurant owners were required to submit

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[59] http://debanked.com/2017/06/district-court-offers-guidance-on-merchant-cash-advances-in-precedent-setting-decision, Mark Dabertin, Special Counsel at Pepper Hamilton, Attorneys at Law, June 6, 2017, Published in deBanked, June 6, 2017.
[60] Id.
[61] Id.
[62] The Merchant Cash Advance Industry May Have a Few Bad Apples, Jordan Stevens, B.1.

"credit applications," make personal guarantees, and provide other documentation consistent with that of a loan. Finally, the transactions carried an interest rate of 152.34% APR equivalent. The court found that the contracts were indeed loans that violated California's 10% maximum interest rate.[63]

The case eventually settled, with Rewards Network not only paying $20 million to the restaurant owners but also forfeiting its claim on $35 million in additional contract payments from the owners. Then in 2008 a similar case against AdvanceMe (now CAN Capital) resulted in a payment of $23.4 million to plaintiffs and the forfeiting of further collections from them. The settlement also required AdvanceMe to add two clauses to its agreements, the first of which said that a merchant bankruptcy would not constitute a breach of contract covenants and the second of which said that, absent any other breach, AdvanceMe would not seek payments from merchants who went out of business during the ordinary course of affairs.[64]

MCA companies in California responded by adding arbitration and class action waiver clauses to their contracts. Some MCA providers, understandably concerned about the cost of litigation, converted their contracts to loans and became licensed lenders or even issued loans through chartered banks. Others closed their California offices and simply stopped doing business there.[65]

The issue of classifying a transaction as a sale instead of a loan might have come out differently with better drafting on the part of Rewards Network. Certainly, the industry now has several persuasive cases demonstrating that a properly drafted MCA contract creates a sale and not a loan. However, some MCA providers believe that one could win in court on the "classification issue," and still lose another way.[66] After all, the MCA contract has been nearly a sole source of institutional funding for small business, especially startups and those with previous credit problems (read: those guys had no other choice). Additionally, the contract is proffered by the MCA provider, usually a sizeable organization, so it's easy to see how the agreements could be seen as unfairly drafted against the merchant. Where provisions are ambiguous and especially when one party is in a superior position (as in much larger) there is a general rule that courts will tend to construe the contract against the drafter.

Because there are multiple risks to MCA providers in these transactions, the terms of the contracts do tend to favor them.[67] Without relying on individual state usury laws, merchants could stipulate that, while they don't fall under the consumer protections of the CFPB, the MCA provider is the drafter of the contract and the high factor rates and APR equivalents are essentially "unfair."

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[63] Id.
[64] Id.
[65] Id.
[66] Id.
[67] Id.

Until the CFPB makes small businesses part of the "consumer" umbrella or until another regulatory agency is appointed to regulate MCAs, the loan-versus-sale issue will continue to arise, and cases will continue to be litigated. Given the anti-regulation view of the current administration, it does not seem likely that federal regulation will overtake MCAs and, under new leadership, the CFPB is unlikely to engage in "mission creep" by announcing that small businesses fall under its consumer mandate. Richard Cordray, the Ohio politician who was appointed as the first head of the CFPB in 2010, has resigned from that position, noting as he departed that during his six-year tenure, the watchdog bureau returned $12 billion to 30 million consumers that had been harmed by financial institutions.[68] The CFPB was the brainchild of Massachusetts Senator Elizabeth Warren, who has now moved on to other priorities. Although the current CFPB leadership is considered temporary, we can expect that the permanent head, whomever he or she turns out to be, will take a less aggressive and more disciplined approach to the original mission.

Treating MCA contracts as loans would create serious problems for small businesses. First, as factor rates are replaced by interest rates and "retained amounts" are replaced by fixed payments with a finite term, the yield on such loans would come crashing down. MCA providers would leave the marketplace for higher returns elsewhere and small businesses would be left to deal with the same banks that turned them down in the first place.

Under such circumstances, the availability of capital would again become scarce and, instead of growing with the economy, some small businesses would have to close. MCA sale contracts, if reconstituted as loans, would likely be high interest subprime loans but they would still provide capital to businesses. Further, as the definition of MCA continues to broaden, and as small business owners improve their credit ratings, some MCA providers are actually writing small business loans, especially for equipment. In the balance between encouraging the growth of small businesses by allowing the market to price risk and ensuring that financial institutions do not take advantage of small entities, government will, as usual, swing back and forth between what incentives they are providing and to whom.

The industry itself continues to argue for self-regulation, similar to that undertaken by other professional groups. At a minimum, self-regulation would entail establishing an organization that, presumably, would collect dues for the purpose of promulgating, communicating, and enforcing its ethical principles and best practices. The creation of an examination for members to pass could replace the need for licensing, increase professionalism, and enhance credibility. If such an effort were to be broad based and successful, MCA could avoid being swept into the aegis of regulation. On the other hand, if behemoths like Wells Fargo, American Express, and PayPal, with their banking histories and consumer nexus, remain heavily involved, it's likely the industry will eventually be brought under some measure of government control.

[68] https://www.usatoday.com/story/money/2017/11/15/richard-cordray-head-consumer-finance-protection-bureau-says-hes-stepping-down/866643001.

VIII. FACTORING AND MCA AS YIELD INVESTMENTS

To invest in factoring and/or MCA the alternative lender will provide financing to the loan originators, i.e., the factoring companies and/or MCA providers. Loan originators will sometimes have financing from a bank. But given the growth rates of both businesses, the factoring companies and MCA providers will inevitably exceed their bank facility's funding and will seek new sources of growth capital.

There are several ways the alternative lender can provide that capital and a myriad of structures that will facilitate the transactions. The lender could make a term loan to the loan originator for an amount that would finance a group of contracts that is acceptable to the lender. The alternative lender could also negotiate a revolving loan – an interest-only loan for a period certain, followed by a revision of the loan agreement. For example, the lender would advance money and accept interest-only payments for a period of, say, six months. After that, the arrangement would be reviewed and either revised or a full amortization schedule would be set up so that the alternative lender would be made whole with payments of both principal and interest over a period of time.

The alternative lender could also work with the MCA or factor originator to set up a Special Purpose Entity ("SPE"). With careful structuring, the SPE can be used to warehouse the originations and may be "bankruptcy remote" from the originator's failure. Originations should be matched against a mutually agreed upon overall program, or criteria set ("Buy Box"). Moreover, the alternative lender should seek "first loss" capital from the originator via an advance rate of less than 100% against originations generated, and/or equity reserves put up by the originator, to provide a cushion against potential defaults. Such "skin in the game," put up by the originator, helps to ensure that interests are aligned between the originator and the lender-investor.

Importantly, the alternative lender is providing the loan originators with growth capital in the form of a loan. Thus, the alternative lender's returns will not be what the factors or MCA providers earn. They will be more in the range of 8% – 14%, not the 28% – 45% gross returns earned by MCA or factor originators.

An 8% – 14% yield would put the alternative lender's loans to the loan originators in the "high yield" category. One of our Evaluation Touchstones is an assessment of the loan originators' ability to pay the alternative lender back. Thus, there is the need to look at the history of the originator's business, historical operations, collateral, cash flows, reputation, financial position, and the like. See Appendix 1. It is also necessary to determine the originator's profitability on this line of business. An evaluation must be made of the originator's ability to repay all of its costs (including any defaults and interest and principal payments to the alternative lender) from the revenue received on its factoring and merchant cash advances over a finite period of time. After all, out of its attractive gross returns, the originator must pay collection costs, staffing costs and technology costs, as well as the cost of the occasional delinquency or outright default. Importantly, the originator must also be able to derive positive net income, even after

payment of borrowing costs, specifically, interest and principal repayment to the alternative lender.

Each yield-generating investment has its own challenges. Most investors recall that reaching for yield by extending duration has been disappointing, especially when interest rates are rising. High yield bonds provided adequate yield for years but, during the Great Recession, became illiquid and almost as volatile as stocks. Speaking of equities, Master Limited Partnerships (MLP) were income favorites – until dividend cuts followed the price of oil downward over the past few years.[69] Real Estate Investment Trusts (REITs), another favorite, currently have cash yields over 4% but remain volatile relative to their pre-Recession levels and are longer duration.[70]

How can risk averse investors attain a superior return without subjecting capital to the volatility of long-duration assets? Selectively investing in factoring and MCA by lending to the originators of those contracts derives a high level of current yield for the investor while allowing the originating lender to participate in business growth throughout this economic recovery.

With respect to duration, factoring typically limits each round of collections to 30 or 45 days, usually with an interest penalty for any receivable that exceeds its expected collection date. Thus, the duration for each round of collections is very short. The MCA contract generally has a greater level of default risk than factoring, necessitating that duration also be kept very short. But there are contract provisions that can help address credit risk in a given MCA contract. For example, the alternative lender, our investor, could tighten overall underwriting standards or ensure there is additional "first loss" capital.

We have given examples, where possible, of ways to apply the Evaulation Touchstones when dealing with the inevitable risk in any investment, including factoring and MCA. Being actively involved in the process allows the alternative lender to insert appropriate provisions, where needed, to protect its investment.

The opportunity to participate in short duration, high yield direct lending with Specialty Finance contract investments is timely. The category has been receiving increasing sponsorship in specialized portfolios in recent years. Factoring provides excellent returns and the MCA industry, having survived its high growth, high risk days, continues to offer investors attractive yield with short duration. Thus, both factoring and MCA represent compelling investments in a short duration income portfolio.

[69] https://www.alerian.com/education/figures-and-tables .

[70] NAREIT® REIT Watch® A Monthly Statistical Report on the Real Estate Investment Trust Industry, October 2017.

Appendix 1: Investor Evaluation Touchstones for Loan Originators (Factors and MCA Providers)

Loan Originator

Entity and/or key principals

1. Search the web for name of principal and firm for any bad acts, and for prior business names and utilization of one cell phone number

2. Ensure in good standing, financially solvent, compliant with all laws and regulations

3. Any and all: litigation, both past and present disclosed; customer complaints; and regulatory actions

4. Identify necessary insurance policies, e.g., E&O, general liability, etc.

5. Financial statements, both year-to-date and prior years

6. Servicer and/or Loan Originator has demonstrable ability to provide timely reporting

7. Ascertain:
   a. All cash controls
   b. If applicable, UCC filings, their timely filing and periodic updating
   c. Financial adequacy of guarantors

8. No related parties to Loan Originator

9. Agreement for periodic inspections

10. Limitations placed:
    a. Debt
    b. Forward flow commitments

11. Periodic verification of borrowing base using field audits

Process

1. Able to provide appropriate monitoring, tracking, of all business processes, policies and procedures – does the Loan Originator actually do what is the agreed-upon process?

2. Allocation of duties and responsibilities are clearly defined and in place between: disparate corporate or partnership entities, individual functions and third-party services, and account obligor and loan originator

Appendix 1 (continued)

3. Any credit scoring mechanisms or algorithms are fully compliant with regulatory standards and objectively understandable

4. Use of brokers to find merchants or receivables sellers – beware of collusion between them to commit fraud, i.e., know the quality of the broker, if used, and understand how broker is compensated

5. Collection process well defined and documented

6. Review contract between merchant receivables seller and loan originator

7. Clear cut limits established for sourcing finders, states, business types, amount to any single borrower

8. Use of credit bureaus

9. Utilization of the Small Business Finance Association database or Data Merch LLC for bad actors or ID Analytics

10. If card processor, an exclusive relationship

11. If ISO is used, what ISO fees are tacked onto the contract?

Underwriting

1. Underwriting guidelines address these risks:
    a. Identity of borrower/account obligor
    b. Ability of borrower to repay/account obligor
    c. Intention of borrower to repay/account obligor

2. Photos of account obligor premises taken by third party or Loan Originator inspector

3. Merchant mix by business type
    a. Any restrictions on higher risk merchant types, e.g., attorneys, collection agencies, debt consolidators, real estate, merchants using virtual offices, etc.

    b. Matrix pricing model and checklist to reflect varying risk categories, e.g., travel agencies, gas stations, oil/energy, etc.

    b. Automatic knockouts

Appendix 1 (continued)

4. No amendments from original terms of account obligors – discover policy on refinancings

5. Conforms to an agreed upon buy box and pricing matrix

6. The receivable has no other encumbrances than those of the Loan Originator

7. Complete documentation of all underwriting criteria relating to each account obligor and related receivable

8. No prior litigation with account obligor

9. Understand merchant or receivable acceptance/decline rates

10. Amount of card chargebacks (MCA)

11. Advance rate percentage against historical sales (MCA)

12. Retention percentage

13. Factor rate including variability by type of merchant

14. Dollar denominated

End borrower, whether Merchant or Receivables Seller

1. Merchant ability to repay

2. Actual financial statements – beware those that might be "new creations." Use of "banc sync" companies for direct financial institution access

3. Legal structure

4. Purpose of funding

5. Months in business and length of ownership

6. Principal FICO score

7. Leasehold terms – ensure regular rent has been paid monthly

Appendix 1 (continued)

8. Ask if use of a “debt consolidation firm” or “settlement firm”

9. Litigation search for any prior bankruptcy

10. Historical sales pattern including splits between cash, credit, and debt payments

Appendix 2: Factoring Terminology[71, 72]

Account Receivable – Evidence of a commercial debt owned by a creditor, usually due within 30 – 90 days. In the factoring industry accounts receivable are what a company (client) sells to a factor in return for an advance payment. The factor then collects the accounts receivable from the company's customers.

Advance – This is the amount of money the factoring company advances to the company when it buys the invoice. It is wired to the company shortly after the invoice is purchased.

Advance Rate – In the factoring industry, advance rates generally range from 70% – 90%. This percentage is the portion of total receivables for which the company receives money immediately from the factor.

Broker – A person who matches potential clients in need of cash with financial entities with access to cash, including factors.

Client – A factoring client is one who sells invoices to the factor.

Charge back – Occasionally, factored invoices become uncollectable. If a factored invoice is deemed uncollectible, the factor charges the client who factored it a specific amount of money (the charge back) based upon the agreed-upon non-payment clause that is in the original factoring contract.

Collateral – The set of invoices the client sells to the factor, which the factor holds until the accounts receivable are paid. If any of the client's customers default on the payment of an invoice, the client forfeits the collateral to the factor.

Collections – Payments that the factor receives for invoices that were factored or payments that flow through the "lockbox" system.

Concentration – Amount of a company's client accounts receivable due from a single customer. It is usually expressed as a percentage a single client represents of the total accounts receivable. Most factors have a maximum level the factor will fund a single customer in the portfolio. This is a risk control measure to ensure that a single account does not represent a large majority of the total invoices.

Creditor – Party to whom money is owed.

Customer – A company that purchases products or services from the factoring client and who will pay the invoice that is factored by the client to the factor.

[71] http://www.Factoringglossary.org, supplemented by Wikipedia, https://en.wikipedia.org/wiki/Factoring.
[72] http://www.fastarfunding.com/glossary, supplemented by Wikipedia, https://en.wikipedia.org/wiki/Factoring.

Appendix 2 (continued)

Debtor (or Account Debtor) – The individual or business that owes money on an account receivable invoice purchased by the factor. The factor interacts directly with the debtor to collect the receivable.

Dilution – The difference between the face amount of an invoice and the amount the account debtor ultimately pays. Dilution is a critical risk in factoring and a high rate of dilution will negatively affect the advance rate. Dilution may be caused by returns, trade allowances, bad debts, slow pays, concentrations, charge backs and other reasons, not known or disclosed to the factor.

Discount Rate – The percentage of the account receivable invoices held back by the factor as its fee. This is also known as a factoring fee.

Due Diligence – Verification process and related documentation given to a factor to facilitate a decision as to whether or not an invoice should be purchased. Also, it can refer to any research undertaken by the factoring company to determine whether to extend factoring services to an applicant.

Factor – Company that provides businesses with operating capital by purchasing their accounts receivable.

Factoring (also known as Invoice Factoring) – The process of purchasing commercial accounts receivable invoices from a business at a discount. A client company sells its accounts receivable to a factoring company in return for an advance on the collection of those receivables. The client company does this to smooth cash flow and provide a source of working capital. The factor's client is known as the "seller," the factoring company is also known as the factor, and the client's customer is also known as the "debtor."

Factoring Fee – The fee the factoring company charges to finance the invoices. It is often expressed as a discount on the gross value of the invoices and as a percentage that increases over time, for example, 1.5% per 30 days, 0.1% per day thereafter.

Funding – Advancing money based on the advance rate to a client.

Funding Period – The time period that starts when the factor purchases the invoices and ends when the customer pays the invoice in full.

Holdback – Also known as a reserve, the amount that the factoring company holds back from its client until an invoice or set of invoices have been paid. It is usually stated as a percentage of the invoice's face value.

Appendix 2 (continued)

Invoice – Also known as a contract or bill of sale, an invoice is a non-negotiable commercial instrument generated by a seller and provided to a buyer. The document generally identifies both parties and lists the items sold or services provided. It mentions shipment date and method of shipment and lists the price, any discounts applied and the terms of delivery and payment. It can serve as a demand for payment and, once fully paid, can serve as a title document.

Invoice Factoring – See Factoring.

Non-Recourse Factoring – A form of factoring in which the factoring company agrees to absorb any credit losses that result from a customer default on an invoice. The most common type of credit loss that is covered with a non-recourse provision in a factoring contract is due to bankruptcy or declared insolvency. Compare to Recourse Factoring.

Notice of Assignment – A notice sent to the customer informing him or her that the invoice has been factored and pledged as collateral. The notice also informs the customer of the new address to which payment should be sent.

Notification – This involves the factoring company notifying the seller's clients that the factoring relationship exists and that all future payments are to be made to the factoring company. All customers of the factor's client receive notification letters disclosing that the factor's client has sold its accounts receivable to the factor.

Personal Guarantee – A contract between a seller and a funding provider (such as a factor) in which the seller accepts liability and personal responsibility for financial obligations.

Rebate – Amount returned to the company by the factor from the reserve amount after invoices have been paid and applicable fees have been deducted.

Recourse or full recourse – Ordinarily, a factor purchases accounts receivable from a merchant/client and assumes all rights of ownership to them. In factoring with recourse, however, the factor retains the right to demand the return of a portion of the amount advanced to the merchant in the event the merchant's client makes no payments on the receivable. Compare with Non-Recourse Factoring.

Reserve Amount – The amount of money not immediately provided to the company factoring its receivables, expressed as a percentage of the Total Invoice Amount (Advance Rate + Reserve = 100% or Total Invoice Amount). This money is transferred to the client once payment is received by the factor. Reserve amounts are segregated into reserve accounts.

Schedule of Accounts – Reports given by the client to the factor. The report lists information about each of the client's customers.

Appendix 2 (continued)

Spot Factoring – Spot factoring, also known as single invoice discounting, allows a company to factor a single invoice or a group of invoices one time. Spot factoring usually carries a cost premium since the factoring company has a lowered level of predictable volume overall and the spot factoring transaction often fails to meet the company's monthly minimums.

UCC1 – UCC stands for Uniform Commercial Code, a uniform act that harmonizes the laws of sales and commercial transactions in all 50 states of the U.S. A Form UCC1, also called a Financing Statement, is a form filed by the creditor, stating that the creditor holds an interest in the property of a non-paying debtor.

Verification – A step during the due diligence process in which a factor confirms the validity of an invoice with the customer.

Appendix 3: MCA Terminology[73, 74]

ACH – Automated Clearing House. ACH payments are deducted, usually daily, from an MCA client's business checking account. ACH debits have largely replaced credit card splits as the ACH payment can encompass the total revenue (cash plus card payments) of the merchant.

Factor Rate – Cost of a Merchant Cash Advance. Rates generally range from 1.1 – 1.5, depending on the risk of the transaction, the lender's policies, and the time frame. The higher the factor rate, the riskier the MCA contract. An MCA factor rate has nothing to do with factoring, another specialty finance product.

Holdback – Percentage of daily credit card collections that are taken from daily credit card receipts and remitted as repayments to the MCA provider.

ISO – Independent Sales Office. Brokers who are engaged in identifying prospective clients for a direct lender.

Lockbox – Third party bank account where funds from a card payment processor or bank account are held. Through an agreement with the credit card processor and with the assent of the merchant, the MCA provider will pull a specified percentage of daily credit card collections from the lockbox account and the remaining receipts will be remitted to the merchant.

MCA – Merchant Cash Advance. A contract which allows for the factoring of *future* credit and debit card receivables. The expected receivables are sold at a discount in return for an advance amount to the merchant.

Remit – Daily ACH payment for a merchant cash advance (MCA) or a split percentage for a credit card split.

Split Percentage (also known as a Credit Card Split) – A split is filed with the merchant's credit card processor for the purpose of splitting the daily credit card receivables between the merchant and the MCA provider. The percentage amount varies depending on the MCA contract and the policies of the provider, including the amount funded and the percentage the provider wants to retain in order to derive a reasonable return on the MCA contract. The split will be taken from every credit card collection batch until the repayment has been satisfied.

Stacking (Double Funding) – The practice of obtaining a second (or third or fourth) MCA contract, each with different providers, for the purpose of increasing the merchant's cash flow. The subsequent MCA contracts are usually used to replace the cash that is being split from card receivables to pay the first MCA contracts. The practice is dangerous to the merchant, the provider, and the investors because they often create a debt spiral for the merchant, from

[73] https://bizlender.com/glossary/.
[74] https://expressbusinessloans.com/merchant-cash-advance-terms-glossary-faq/.

Appendix 3 (continued)

which it is difficult to successfully emerge. Such “stacks” are not reported to the original MCA provider(s) or its investors.

Syndicate – A program that direct lenders offer to ISOs and others to participate in cash advance deals.