



## OVER THE TOP DOWN UNDER

**MADDEN VS.  
MIDLAND FUNDING, LLC:**  
WHAT DOES IT MEAN  
FOR ALTERNATIVE SMALL  
BUSINESS LENDING?

By Patrick Siegfried

**COMMISSION CHARGEBACKS:**  
THE GOOD, THE BAD AND  
THE UGLY

By Cheryl Winokur Munk

▶ **Foreign and domestic  
players are joining the  
fledgling Australian  
alternative finance market  
at a dizzying pace.**



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By ED MCKINLEY

FOREIGN AND DOMESTIC PLAYERS ARE JOINING THE FLEDGLING AUSTRALIAN ALTERNATIVE FINANCE MARKET AT A DIZZYING PACE.

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# Letter From the Editor

**BY  
SEAN MURRAY**

G'day mates,

Merchant cash advance and similar financial solutions have expanded beyond the United States. Canada was always the next logical option but it's made its way far beyond that, all the way to Australia. And in the land down under, Australian natives are competing with American-based companies for market share. There's not a lot of information available about the landscape there so we went out and got the inside scoop, *fair dinkum!*

Speaking of international, the race is on here at home to obtain a national or state bank charter. Loans allow for much more customization than is possible with merchant cash advances, noted Glenn Goldman, CEO of Credibly. But is the industry setting itself up for a stable future or are some companies betraying their roots as a bank alternative by in essence becoming banks themselves?

And even while the crowd cheers for charters, a baffling appellate court ruling in New York State threatens to undermine that strategy completely. If you haven't heard of *Madden v. Midland Funding*, we've got some information about it inside.

I must note that deBanked celebrated its 5-year anniversary this past July. The world was much simpler when I started it. In 2010, I was able to quantify the industry's size with ease, but today it's a challenge to define what the industry even is, let alone calculate how big it is.

Everything is evolving and quickly, but some things still say the same, like when a broker's commission is pulled back because a deal defaulted. Shouldn't lenders take full responsibility for their own underwriting decisions? Not all brokers thought so apparently when we asked them. It appears that today's broker is thinking more like a lender and if long-term growth is one of their goals, they're probably thinking about becoming a lender themselves. That of course brings us right back to bank charters and court rulings to make that possible.

And if those topics are exhausting to think about, then sit back, relax and let us guide you through the beautiful Australian Outback. From Uluru to a kangaroo, alternative lending is never out of reach.

—Sean Murray



# OVER THE TOP DOWN UNDER

By **ED MCKINLEY**

Foreign and domestic players are joining the fledgling Australian alternative finance market at a dizzying pace.

**S**an Francisco had its gold rush, Oklahoma had its land rush and now Australia is experiencing a rush of alternative funding. After a slow start a few years ago, foreign and domestic companies have been flocking to the market down under in the last 18 months.

As many as 20 new alt-funders are doing business in Australia, but that number could swell to a hundred, said Beau Bertoli, joint CEO of Prospa, a Sydney-based alternative funder. “The market in Australia has been very ripe for alternative finance,” Bertoli, said. “We see an opportunity for the alternative finance segment to be more dominant in Australia than it is in America.”

Recent entrants to the embryonic Australian market include Spotcap, a Berlin-based company partly funded by Germany’s Rocket Internet; Australia’s Kikka Capital, which gets tech backing from U.S.-based Kabbage; America’s OnDeck, which is working with MYOB, a software company; Moula, which began offering funding this year but considers itself ahead of the curve because it formed two years ago; and PayPal, the giant American payments company.

The new entrants are joining ‘pioneers’ that have been around a few years, like Prospa, which has been working for three years with New York-based Strategic Funding Source, and AUSvance, which came to market in 2008 with merchant cash advances and started offering small-business loans in 2012.

Some don’t take the newcomers that seriously. “There are small players I’ve never heard of,” said John de Bree, managing director of Sydney-based

AUSvance, in a reference to local Australian funders. “The big ones like OnDeck and Kabbage don’t have the local experience.”

But many players view the influx as a good sign. “I think it’s an endorsement of the market,” Bertoli said. “There’s more publicity and more credibility for what we’re doing here in terms of alternative finance.” It’s like the merchant who gets more business when a competing store opens across the street.

Besides, the market remains far from crowded. “I’m not concerned about the arrival of OnDeck and Kabbage because it really does validate our model,” maintained Aris Allegos, who serves as Moula CEO and cofounded the company with Andrew Watt.

The market’s relatively small size – at least compared to the U.S. – doesn’t seem to bother players accustomed to the heavily populated U.S., a development some observers didn’t expect. “I’m very surprised,” de Bree said of the American interest in Australia. “The American market’s 15 times the size of ours.”

Others see nothing but potential in Australia. “This is a market that will evolve over time, and we think the opportunity is enormous,” said Lachlan Heussler, managing director of Spotcap Australia.

Some view the Australian rush to alternative finance not so much as a solitary phenomenon but instead as part of a worldwide explosion of interest in the segment, driven by banks’ reluctance to provide loans since the financial crisis, de Bree said.

Viewed independently or in a larger context, the flurry of activity in Australia is new. “The boom



is probably only getting started,” Bertoli maintained in a reference to the Australian market. “Right now, it’s about getting the foundation of the market established.”

To get the business underway in Australia, alternative funders are alerting small-business owners and the media to the fact that alternative funding is becoming available and teaching them how it works, de Bree said. “Half of our job is educating the market,” noted Heussler.

New players are building the track record they need to bring down the cost of funds, according to Allegos. “Our base rate is 2 percent or 3 percent higher than yours,” he said, adding that the cost of funds is more challenging than gearing up the tech side of the business.

Although the alternative-lending business started later in Australia than in the United States and lags behind America in exposure, it’s maturing rapidly, said de Bree. Aussie funders are benefitting from the lessons their counterparts have learned in the U.S., he said.

But the exchange of information flows both ways. Kabbage, for example, chose to enter the

Australian market with a local partner, Kikka. Kabbage learned from its earlier foray into the United Kingdom that it makes sense to work with colleagues who understand the local regulatory system and culture, said Pete Steger, head of business development for Atlanta-based Kabbage.

Such differences mean that risk-assessment platforms that work in the United States or Europe require localization before they can perform effectively in Australia, sources said.

Sydney-based Prospa, for example, got its start three years ago and has been working ever since with New York-based Strategic Funding Source to

localize the SFS American risk-assessment platform for Australia, said Bertoli, who shares the company CEO title with Greg Moshal.

Moula, which has headquarters in Melbourne, sees so many differences among markets that it decided to build its own local platform from scratch, according to Allegos.

One key difference between the two markets is that Australia does not have positive credit reporting. “We have nothing that even comes close to a FICO score,” said Allegos. The only credit reporting centers on negative events, he said.

Without credit scores from credit bureaus, funders base their assessments of credit worthiness largely on transaction history. “It’s cash-flow analytics,” said Allegos. “It’s no different from the analysis you’re doing in your part of the world, but it becomes more significant” in the absence of positive credit reporting, he said.


Australia lacks credit scores at least partly

because the country’s four main banks control most of the financial sector and choose not to release credit information, sources said. The banks have warded off attacks from all over the world because the regulatory environment supports them and because their management understands how to communicate

with and sell to Australian customers, sources said.

The big banks – Commonwealth Bank, Westpac, Australia and New Zealand Banking Group, and National Australia Bank – set their own rules and have kept money tight by requiring secured loans and long waiting periods, Bertoli said. It’s difficult for merchants who don’t fit into a “particular box” to procure funding, he maintained. “It’s almost like an oligarchy,” Allegos said of the banks’ grip on the financial system.

Eventually, the banks may form partnerships with



**SOME VIEW THE AUSTRALIAN RUSH TO ALTERNATIVE FINANCE NOT SO MUCH AS A SOLITARY PHENOMENON BUT INSTEAD AS PART OF A WORLDWIDE EXPLOSION OF INTEREST IN THE SEGMENT, DRIVEN BY BANKS’ RELUCTANCE TO PROVIDE LOANS SINCE THE FINANCIAL CRISIS...**



alternative lenders, but that day won't come soon, in Allegos' estimation. It could be 12 months or more away, he said.

Even as the financial system evolves, deep-seated differences will remain between Australia and the U.S. Most Americans and Australians speak English and share many views and values, but the cultures of the two countries differ greatly in ways that affect marketing, Bertoli said. "In your face" advertising that can work well with "loud, confident" Americans can offend the more "laid-back" Australian consumers and business owners, he said.

Australians have become tech-savvy and comfortable with online banking, but they guard their privacy and often hesitate to reveal their banking information to a funding company, Allegos said. The entrance of OnDeck and Kabbage should help familiarize potential customers with the practice of sharing data, he predicted.

Cost structures for businesses differ in Australia from the U.S., Bertoli noted. Australian companies pay higher rent and have to pay minimum wages set much higher than in the United States, he said. Published reports set the Australian minimum wage at \$13.66 U.S. dollars. The higher costs down under can take a toll on cash flow. "Take an American scorecard and apply it to Australia?" Bertoli asked rhetorically. "You just can't."

Distribution's not the same for commercial enterprises in the two countries, Bertoli maintained. Despite having about the same geographic area as America's 48 contiguous states, Australia has a population of 23 million, compared with America's 322 million.

No matter how many people are involved, changing their habits takes time. Australian merchants prefer fixed-term loans or lines of credits instead of merchant cash advances, Bertoli said. In many cases Australian merchants simply aren't as familiar as Americans are with advances, Allegos said.

Besides, the four big banks in Australia tend to solicit merchants for credit and debit card transactions without the help of the independent sales organizations and sales agents. In the U.S., ISOs and agents play an important role in explaining and promoting advances to merchants, Bertoli said. Advances make sense for merchants because advances

adjust to cash flow, and they help funders control risk, but just haven't caught on in Australia, Bertoli said. Australians resist advances if too many fees are attached, said Allegos.

Pledging a portion of daily card receipts might seem too frequent, too, he said. Besides, advances are limited to merchants who accept debit and credit cards, while any business could conceivably choose to take out a loan, said de Bree.

Advances have to compete with inventory factoring, which has become a massive business in Australia, according to Heussler. The business can become intrusive because funders may have to examine balance sheets and talk to customers, he said.

Australia's reluctance to turn to advances, leaves most alternative funders promoting loans and lines of credit. Prospa, for example, uses some brokers to that end but also relies on online connections, direct contact with customers, and referrals from companies that buy and sell with small and medium-sized businesses.

"Anyone that touches a small business is a potential partner," said Heussler, including finance brokers, accountants, lawyers and even credit unions, which have the distribution but not the product.

Moula finds that most of its business comes from well-established companies and that loans average just over \$27,000 in U.S. currency and they offer loans of up to more than \$77,000 U.S. The company offers straight-line, six- to 12-month amortizing loans.

Using a model that differs from what's common in the U.S., Moula charges 1 percent every two weeks, collects payments every two weeks and charges no additional fees, Allegos said. A \$10,000 (Australian) loan for six months would accrue \$714 (Australian) in interest, he noted.

Spotcap Australia offers a three-month unsecured line of credit and doesn't charge customers for setting it up, Heussler said. If the business owner decided to draw down, it turns into a six-month amortizing business loan for up to \$100,000 Australian. Rates vary according to risk, starting at half a percent per month but averaging 1.5% per month.

If companies have all of the necessary information at hand, they can complete an application in







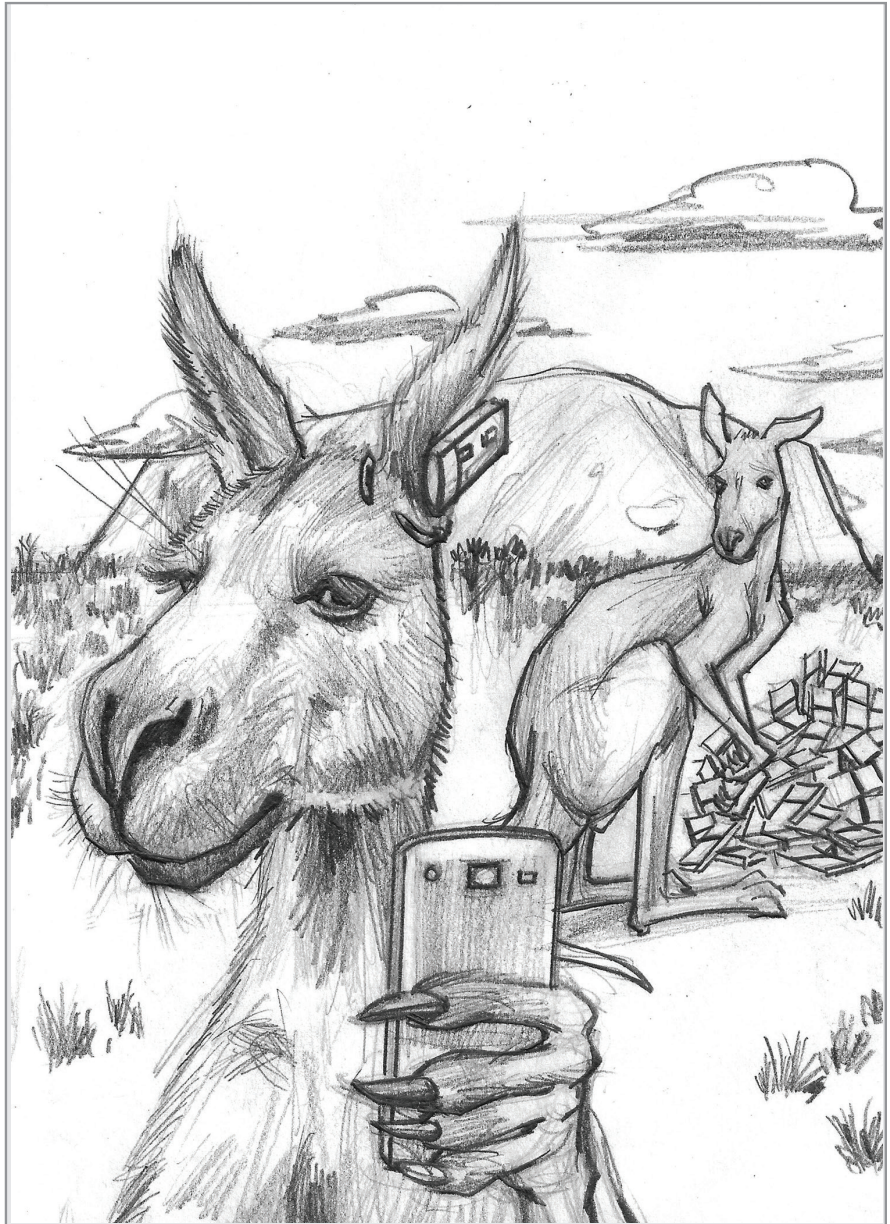
10 minutes, Allegos said. Moulas has to research some applications offline if the company's structure deviates too greatly from the usual examples – much the same as in the U.S., he maintained. The latter requires strong customer-service departments, he said.

Kikka uses a platform based on the Kabbage model, which gives 95 percent of customers a 100-percent automated experience, Steger said. "It goes to show the power of our automation, our algorithms and our platform," he maintained.

Spotcap prefers to deal with businesses that have been operating for at least six months, Heusler said. The funder examines records for Australia's value-added tax and other financials, and it likes to connect with the merchant's bank account. Spotcap can usually gain access to the account information through cloud-based accounting systems and thus doesn't require most companies to download a lot of financial documents, he noted.

Despite the differences between the two countries, banking regulations bear similarities in Australia and the United States, sources said. In both nations the government tries harder to protect consumers than businesses because they assume business owners are more financially savvy. For consumers, regulators scrutinize length of term and pricing, sources said, and on the commercial side the government is concerned about money laundering and privacy.

Regulation of commercial funding will probably intensify, however, to ward off predatory lending, Bertoli said. Government should consult with businesses before imposing rules, he said. A couple of alternative business funders aren't transparent with their pricing and they charge several fees – that sort of behavior will encourage regulation, Allegos said.



"I know they're watching us – and watching us very closely," he added.

In general, however, the Australian government supports alternative finance, Bertoli said, because they want there to be options other than the four big banks and wants small business to have access to capital. Small businesses account for 46 percent of economic activity in Australia and employ 70 percent of the workforce, he noted, saying that "if small businesses are doing badly, the economy is doing badly."

Hence the need, many in the industry would say, for more alternative funding options in Australia.



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# DEBT CONSOLIDATION: A PARTNER TO ALTERNATIVE LENDERS?

By SEAN MURRAY

Call it the flip side of the coin, the part of the universe that helps consumers get out of debt, rather than take more on. Debt settlement, as it's called, has a bit of a murky reputation thanks to a number of unscrupulous players that operated prior to the implementation of the Telemarketing Sales Rule in 2010.

On October 27th, five years ago, for-profit companies that sold debt relief services over the phone could no longer charge a fee before they settled or reduced a customer's unsecured debt.

"That law forever changed the industry for the better," said a company representative at National Debt Relief (NDR), a New York City-based debt settlement firm.

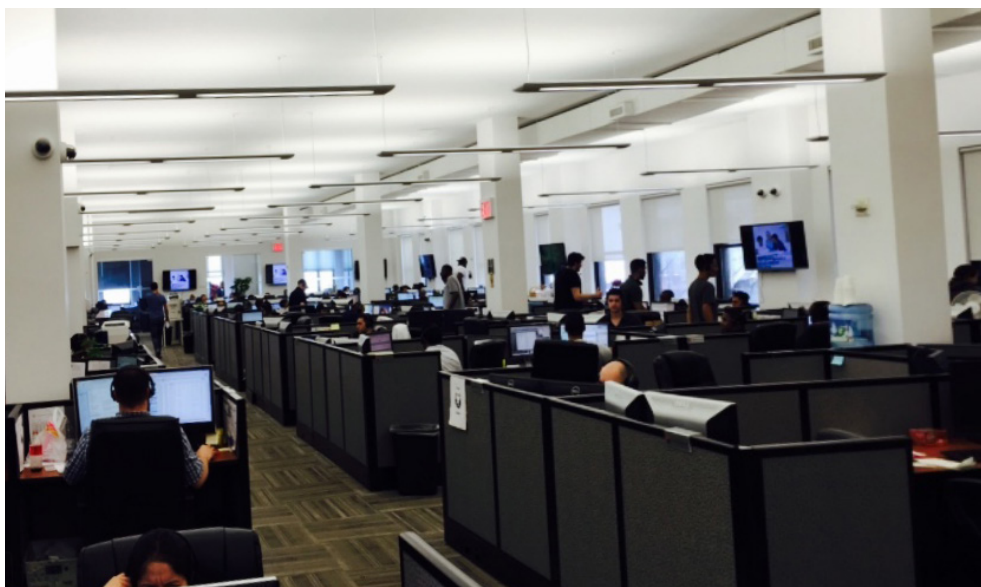
Located right in front of the Bull at 11 Broadway, NDR occupies two floors and employs over four hundred people. And while it may seem that their business model is at odds with the dozens of loan brokers that operate in the neighborhood, they're actually finding ways to work together.

"We're monetizing their declines," said a company representative. Indeed, alternative lenders like to talk about the amount of loans they can issue, but thousands of consumers are ultimately declined.

What those consumers do next and where they go is a storyline that doesn't get much attention. NDR offers to the consumer an alternative route to become debt free in 36 months.

"NDR is enrolling thousands of consumers per month," said a company representative. The A+ BBB rating and firm regulatory compliance has enabled them to land several strategic partnerships in this industry ranging from merchant cash advance companies to peer-to-peer lenders.

"We've found that 36% of declines from alternative lenders fit our criteria," said a company representative. Too much debt is one obvious reason that applicants are getting declined from some of these companies in the first place. And to that end, NDR strives to provide them relief. One condition however is that the client not use credit while in the program.



NDR operates in 42 states and requires a minimum of \$10,000 of unsecured debt to be eligible. They are also an accredited member of the American Fair Credit Council, a consumer credit advocacy association that touts the strictest code of conduct in the industry.

At the 2015 LendIt Conference in NYC, NDR stood out as a Gold Sponsor.

"Everybody wanted to know what we did," said Michael Drehwing who was there as the company's representative. "I told them we want to monetize your declines. How simple is that?"



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# MADDEN VS. MIDLAND FUNDING, LLC: WHAT DOES IT MEAN FOR ALTERNATIVE SMALL BUSINESS LENDING?

By PATRICK SIEGFRIED

On Friday, May 22, 2015, while the rest of us were gearing up for the long Memorial Day weekend, three judges of the United States Court of Appeals for the Second Circuit quietly issued their decision in *Madden v. Midland Funding, LLC*<sup>1</sup>. Though issued to little fanfare, the decision—if upheld on appeal—may lead to significant changes in consumer and commercial lending by non-bank entities.

Loans that were previously only subject to the usury laws of a single state may now be subject to more restrictive usury laws of multiple jurisdictions. Commercial transactions that could be affected include short-term loans by a number of alternative small business lenders.

## THE CASE

The plaintiff, Saliha Madden, opened a credit card account with a national bank in 2005. Three years later, Madden's account was charged off with an outstanding balance. The account was later sold to Midland Funding, LLC, a debt purchaser.

In November 2010, Midland sent a collection letter to Madden's New York residence informing her that interest was still accruing on her account at the rate of 27% per year. In response, Madden filed a class action lawsuit against Midland and its servicer. In her complaint, Madden alleged that Midland had violated state and federal laws by attempting to collect a rate of interest that exceeded the maximum rate set by New York State's usury laws. Midland countered that as a national bank assignee, it was entitled to the preemption of state usury laws granted

to national banks by the National Bank Act (the "NBA"). The district court agreed with Midland and entered judgment in its favor. Madden appealed to the Second Circuit.

After reviewing the record, the Court of Appeals reversed the district court's decision. The appellate court found that the NBA's preemption provision did not apply to Midland as a mere bank assignee. Instead, the court held that in order "[t]o apply NBA preemption to an action taken by a non-national bank entity, application of state law to that action



must significantly interfere with a national bank's ability to exercise its power under the NBA." The court explained that the NBA's preemption protections only apply to non-bank entities performing tasks on a bank's behalf (e.g. bank subsidiaries, third-party tax preparers). If a bank assignee is not performing a task on a national bank's behalf, the NBA does not protect the assignee from otherwise applicable state usury laws. Therefore, as Midland's collection efforts were performed on its own behalf and not on behalf of the national bank that originated Madden's account, the appellate court found that New York's usury laws were not preempted and that Midland could be subject to New York's usury restrictions.



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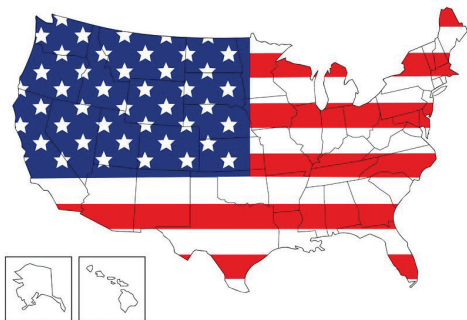
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## USURY LAW COMPLIANCE

The *Madden* decision undermines a method of state usury law compliance that I'll refer to as the "exportation model". In a typical exportation arrangement, a non-bank lender contracts with a national bank to originate loans that the lender has previously underwritten and approved. After a deal has been funded, the bank sells the loan back to the lender for the principal amount of the loan, plus a fee for originating the deal.

<sup>1</sup>F.3d ---, 2015 U.S. App. LEXIS 8483 (2d Cir. N.Y. May 22, 2015).

The exportation model allows non-bank lenders to benefit from the preemption protections granted to banks under the NBA. Specifically, the NBA provides that a national bank is only subject to the laws of its home state. This provision allows a bank to 'export' the generally less restrictive usury laws of its home state to other states where it does business. As bank assignees, lenders that have purchased loans from a bank are only subject to the laws of the originating bank's home state. This exemption saves these non-bank lenders from having to engage in a state-by-state analysis of applicable usury laws.

The *Madden* decision, however, casts doubt on the ability of these non-bank assignees to benefit from the NBA's preemption protections. The Second Circuit's decision makes clear that non-bank assignees that are not performing essential acts on a bank's behalf—which would seem to include alternative small business lenders—are not entitled to NBA preemption and are subject to the usury laws of the bank's home state as well as any otherwise applicable state's usury laws.



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## AFTERMATH

While the Court of Appeals' decision foreclosed Midland's preemption argument, other issues remained unresolved. Specifically, the circuit court did not decide whether the choice-of-law provision in Madden's cardholder agreement—which provided that any disputes relating to the agreement would be governed by the laws of Delaware—would prevent Madden from alleging violations of New York State usury law.

In the district court proceeding, both parties had agreed that if Delaware law was found to apply, the 27% interest rate would be permissible under that state's usury laws. The district court, however, did not address the choice-of-law issue because the court had found that the NBA's preemption protections were sufficient grounds upon which to resolve the

case. As the issue had not been addressed, the circuit court remanded the case back to the district court to decide which state's law controlled.

But before sending the case back down, the appellate court made two points worth noting. First, the court stated that “[w]e express no opinion as to whether Delaware law, which permits a ‘bank’ to charge any interest rate allowable by contract...would apply to the defendants, both of which are non-bank entities.” The court's statement suggests that it may not have completely agreed with the parties that 27% would be a permissible interest rate under Delaware law.

Second, the court highlighted a split in New York case law on the enforceability of choice-of-law provisions where claims of usury are involved. Generally, courts will refuse to enforce a

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AN ISSUE OF PUBLIC POLICY, THE  
ENFORCEABILITY OF SUCH CLAUSES IS  
COMMONLY A POINT OF CONTENTION  
IN USURY ACTIONS...**

choice-of-law provision if the application of the chosen state's law would violate a public policy of the forum state. As usury is sometimes considered an issue of public policy, the enforceability of such clauses is commonly a point of contention in usury actions. The cases cited by the Court of Appeals show that some courts in New York have enforced choice-of-law provisions—even where the interest rate permitted by the chosen state would violate New York's usury laws—while other New York courts have refused to enforce such provisions in light of public policy concerns.

New York, however, is by no means the only state with usury laws that are less than straightforward. The general complexity of state usury laws is evidenced by the circuit court's hesitation to agree with Madden's concession that a 27% interest rate would be permissible under Delaware law. The court made clear that an argument could be made that the rate was usurious under both New York and Delaware law.

### **MADDEN'S IMPACT**

An important legal principle that was not addressed in either the district or circuit court proceedings is the 'valid when made' doctrine of assignment law. The 'valid when made' doctrine provides that a loan that is valid at the time it is made will remain valid even if the loan is subsequently assigned. This doctrine may have led to

a different outcome in the case had Midland argued it before the district or circuit court. Midland is now appealing the Second Circuit's decisions and many expect a 'valid when made' argument to be a primary point of Midland's appeal. If this argument is successful, the practical impact of Madden would be greatly diminished.

In the meantime, the *Madden* decision will likely increase the importance of choice-of-law analysis in relation to usury law. Assignees that previously relied on the NBA's preemption provision as a method of state usury law compliance will now need to address the enforceability of their contractual

choice-of-law clauses where claims of usury may become an issue. This analysis is often a complex undertaking because states take varying views of what constitutes usury as well as whether or not usury is an issue of public policy.

While the *Madden* decision may have been published before the long Memorial Day weekend, analyzing its consequences will likely keep many non-bank lenders (and their attorneys) busy, even on their days off.

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# deBANKED: ALTERNATIVE LENDING BECOMING LESS ALTERNATIVE

By ED MCKINLEY



**REGULATIONS MAKE FORMING OR ACQUIRING A BANK SO DIFFICULT THAT BUSINESSES THAT WANT TO MAKE SMALL LOANS AT HIGH RATES EXTREMELY DIFFICULT...**

Alternative funders are looking a little more like bankers these days, but that's not to say they're developing a taste for pinstriped three-piece suits and pocket watches on gold chains. They're promoting bank loans, applying for California lending licenses and contemplating the unlikely possibility that one day they'll obtain their own bank charters.

"It's what everybody's talking about," said Isaac Stern, CEO of Yellowstone Capital LLC, a New York-based funder. "If it's not in their current plans, it's in their longer-term plans over the next three to five years."

Funders promote bank loans to drive down the cost of capital, sell a wider variety of products, offer longer terms and bask in the prestige of a bank's approval, said Jared Weitz, CEO of United Capital Source.

Loans allow for much more customization than is possible with merchant cash advances, noted Glenn Goldman, CEO of Credibly, which was called RetailCapital until a little less than a year ago. The name changed as the company began offering loans in addition to its original advance business. It's now working with three banks.

While the terms don't vary much with advances, borrowers can pay back loans daily, weekly, semi-monthly or monthly, Goldman said. Loans can also include lines of credit that borrowers draw down only when they choose. Interest rates on loans can

vary, too, he said, and loans can come due after differing periods of time.

Besides that flexibility, loans also offer familiarity among merchants and sales partners – unlike the sometimes baffling advances, Goldman said, adding that "everybody knows what a loan is, right?"

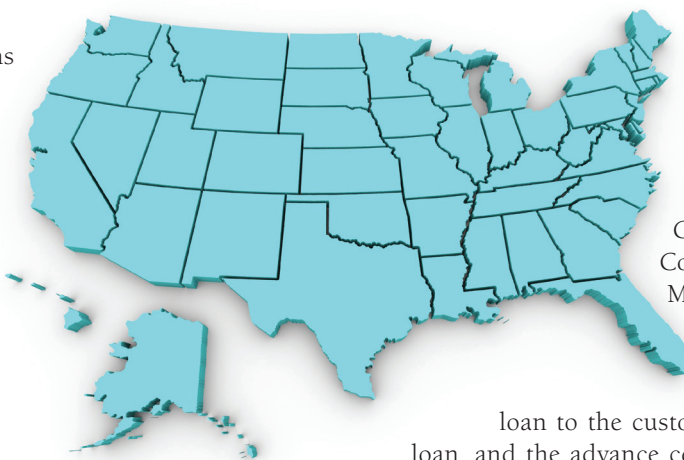
Loans have so many advantages over advances that Credibly expects its loan business to grow more quickly than its advance business, said Goldman, who was formerly CEO of CAN Capital.

Those advantages are also encouraging other advance companies to form partnerships with banks to provide merchants with loans that aren't subject to state commercial usury laws, said Robert Cook, a partner at Hudson Cook LLC, a Hanover, Md.-based financial-services law firm.

The advance company markets the loan to the customer, the bank makes the loan, and the advance company buys it back and services it at the rate the bank is allowed under federal law, Cook said. The bank doesn't lose any capital, it takes on virtually no risk and it profits by collecting a few days' interest or a fee, he noted.

Where the bank's located can make a big difference. A bank based in New York, for example, can charge only 25 percent interest no matter where the customer resides, while New Jersey allows banks to collect unlimited interest anywhere in the country, Cook said.

But the partnerships funders are forming with banks could face a threat. The United States Court of Appeals for the Second Circuit ruled in May in





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Madden v. Midland Funding LLC that a non-bank that buys a loan cannot charge interest set where the bank is located but must instead charge interest according to the laws of the state where the consumer is located, Cook noted. That could mean a lower rate.

In Cook's view the case was poorly argued, the decision was wrong and the ruling may be reversed, "but it has to trouble someone who is thinking about starting up a bank partnership," he said.

The court was asked whether the rules that apply to a national bank also apply to the non-bank that bought the loan, Cook maintained. That's not the question, he asserted. The argument should have been that the idea of "valid when made" should take precedence. It states that a transaction that's not usurious when it's made doesn't become usurious if a party takes action later – like reassigning the note, Cook said.



Meanwhile, offering bank loans isn't the only way alternative funders are coming to resemble banks. Some are obtaining what's formally called a California Finance Lenders License that enables them to make loans in that state.

California began requiring the license in response to lawsuits over the cost of advances. The state has published a licensee rulebook that's about the size of an old-school New York phone book – the kind kids sat on to reach the dining room table, according to Yellowstone's Stern, who completed the licensing process three years ago.

Getting the license took 15 or 16 months and required lots of help from the legal team at Hudson Cook, Stern said. The state investigated his background and fingerprinted him. The cost, including lawyers' fees came to about \$60,000, he recalled.

"Man, it was like pulling teeth to get that license," Stern said. Keeping it's not easy, either. "We guard

that thing fiercely," he maintained. "They'll take away your license if you even sneeze the wrong way."

The hassles have paid off, though, because Yellowstone now deals directly with California customers instead of sharing the profits with other companies licensed to operate there. What's more, companies that don't have licenses are sending business Yellowstone's way.

Retaining the profits from loans is also prompting some funders to contemplate applying for their own bank charters. But Cook, the attorney from Hudson Cook, sees little or no chance of that happening.

Federal bank regulators are reluctant to grant charters to mono-line banks – institutions that perform only one financial-services function, Cook said. "It's risky to put all your eggs into one basket," he maintained.

Regulations make forming or acquiring a bank so difficult for businesses that want to make small loans at high rates, Cook said. "If that's going to be their business plan, they're not going to get a bank." A state charter requires the approval of the Federal Deposit Insurance Corp., which isn't likely, he noted.

Utah industrial banks and Utah industrial loan companies are insured by the Federal Deposit Insurance Corp. but aren't considered bank holding companies, Cook said. However, that's a regulatory loophole that may have closed and thus may no longer offer a way of becoming a bank, he noted.

Clearly, the complications surrounding bank loans, lending licenses and bank charters mean that becoming more bank-like requires more than a pinstriped suit.





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# COMMISSION CHARGEBACKS: THE GOOD, THE BAD AND THE UGLY

By CHERYL WINOKUR MUNK

Imagine you're a 20-something-year-old broker who's just, in good faith, referred a merchant to a funder. You walk away with a few thousand dollars in your pocket, and you promptly spend it on rent and a celebratory steak dinner. Then all of a sudden...BAM! Just like that the merchant goes belly up and the funder's knocking on your door to clawback your hard-earned commission money, which, of course, you've already spent.

For many brokers, it's a familiar-sounding story—with an ending they'd like to rewrite. Their thinking goes like this: underwriters, not brokers, are the ones who are supposed to dig into a company's finances before approving a deal. Underwriters, not brokers, are the ones who make the financial decisions about whether or not a deal can go forward. Therefore, underwriters, not brokers, should be responsible when deals implode.



"There are a lot of people who think there should not be commission clawbacks—that they're unfair," says Archie Bengzon, who runs the New York sales office for Miami-based Rapid Capital Funding, a direct funder. Bengzon was previously the president of Merchant Cash Network, an ISO in New York.

While there's a fair amount of closed-door grousing by brokers, most funders are standing their ground—with only a select few companies kicking these controversial policies to the curb. More commonly, funders claim clawbacks, despite being hated by brokers, are a necessary evil. These funders say that without them, they'd stand to lose too much on bad deals and that they need a way to protect themselves from rogue brokers.

"There is a group of people out there who are trying to game the system," says industry attorney Paul Rianda, who heads a law firm in Irvine, California.

## THE CASE FOR SCRAPPING CLAWBACKS

Brokers in favor of changing the status quo understand the need to prevent bad apples from smelling up the entire industry. But even so they believe that chargebacks are patently unfair to the honest majority of brokers who often make just enough to scrape by. In most cases, the brokers are typically young—18-to-26-year-olds trying to make money and learn the industry. They



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don't have the financial resources that the funders do and the onus shouldn't be on them if the deal they brought in—with good intentions—goes bust in a short time, according to the owner of a top-tier ISO/Hybrid in Staten Island, New York, who requested his name not be used.

This is especially true in cases where the underwriter took risks they shouldn't have or decided to fund merchants in cases where they shouldn't have. "It's the underwriter's job to protect the money that their company is lending out," he says. "[Chargebacks] shouldn't be going on in this industry."

One solution might be for more ISOs to stand up to funders and refuse to send them future deals. That's exactly what the Staten Island executive did a few years ago when a funder he repeatedly worked with tried to claw back his commission on a particular deal. He made a big stink and told them he'd never send them business again. It was enough of a threat to convince the funder to back off. "If more ISOs start saying that...then the funders will start sweating and change their contracts. Because it really isn't fair," he says.

For some brokers, however, taking such a strong position with funders is a risky strategy in a cottage industry where all the major players know each other and there's no shortage of hungry young brokers willing to do business. So while these brokers don't like losing money, they aren't necessarily loudly crying foul either.

Matthew Ross, managing member of Go Ahead Funding, a broker and funder in Basalt, Colorado, has been in the business for nine years. He's only had one commission clawed back once in this time period—it was a commission for \$1,500 on a \$25,000 deal that went sour within a month, he recalls. He was upset at the time and felt the underwriter should have done more to vet the merchant who went belly up. "Why didn't the underwriters catch this?" he remembers asking at the time.

Nonetheless, Ross was a lot calmer than some brokers might have been under the circumstances. For instance, he says he never threatened to stop sending the funder business as many brokers might have done. "I don't necessary like it, but I understand it. I'm not going to fight it," he says.

Some brokers are making their displeasure with the practice known by declining to sign contracts that contain clawback clauses. Nathan Abadi, founder and president of Excel Capital Management, a New York-based funder and ISO, says he either refuses to do business outright or he comes to a verbal agreement with a funder that he'll wait two weeks for payment to make sure the deal has legs. "I meet them in the



middle," he says.

The reason he likes this approach is that it's more palpable for brokers to lose paper commissions versus actual money that they've already been given and possibly spent. Otherwise, as a business owner working with numerous brokers, it's bad for business. "It causes an internal conflict because now you have to penalize the person who's working for you," Abadi says.

### THE FLIP SIDE OF THE CHARGEBACK COIN

Meanwhile, there's a whole other camp within alternative funding—including some brokers—who feel chargebacks are important as a fraud-deterrent. Given the fact that the industry is still largely unregulated, many believe that funders need some type of fire retardant to prevent being burned by unscrupulous brokers.

"We think that they serve an important role," says Stephen Sheinbaum, founder of Merchant Cash and Capital, a New York-based funder. "Most of our stronger referral partners do not object to it. It's a way of aligning our interests with the sales force."

About 60 percent of the company's funding business comes from third-parties including ISOs; its direct sales force accounts for the other 40 percent.

Even some brokers concede that clawbacks can serve a valuable purpose. Sure, it's aggravating to lose money, but they feel that without clawbacks the industry would be even more of a free-for-all than it already is.

"I can see both sides," says Bengzon, the funder

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and broker. Wearing his broker hat, Bengzon has felt the sting of losing a commission once or twice in the 100 or so deals he's done. But he still understands why funders—who take a big monetary hit when deals go sour—would want to protect themselves and require brokers to have some skin in the game.

"If we're going to reap the rewards of a nice commission, we should also understand that it can still be taken away if a deal goes bad," he says.

When he sends leads to funders, Ross of Go Ahead Funding says he does his best to make sure he's sending only high quality merchants. He tries to vet them upfront—to the limited extent he can—in order to avoid problems later on. Clawback provisions serve as "an incentive for [brokers] to keep their eyes open," he says.

### KNOW WHAT YOU'RE SIGNING

About 80 percent of the agreements that come across the desk of Rianda, the industry attorney, have a 30-day clawback provision. But he's seen some agreements that have longer time frames—60, 90 or even 120 days. Those types of contracts aren't as common, but they're out there.

It's important for brokers to carefully read the fine print of a contract before signing on the dotted line. "It sounds obvious, but a lot of people don't do that," says Bengzon of Rapid Capital Funding.

The shorter the clawback time frame, the less brokers tend to balk. "People don't want to be paid on a deal and three months later they lose that commission, which they've already spent," he says.

Bengzon believes a clawback that extends any

more than a month is excessive. "I would never sign something greater than 30 days," he says.

According to Sheinbaum of Merchant Cash and Capital, 30 days is an appropriate time frame to help weed out fraud without putting unnecessary burden on brokers who are sending legitimate business. "The purpose of the provision is to try and stop people from committing fraud at the outset," he says.



David Sederholt, executive vice president and chief operating officer at Strategic Funding Source Inc. in New York, says clawback provisions in the contracts Strategic uses range from 30 to 45 days depending on the contract. He says he understands brokers don't like them, but that it's nonetheless important to have the provision in order to protect the funders. "There's got to be some partnership involved here," he says.

### CLAWBACKS NOT A FREE-FOR-ALL

Many funders recognize that there's a fine line between protecting their business and cutting off potential revenue sources.

"You start clawing back commissions on every default, a broker will stop sending business," says Ross of Go Ahead Funding.

Sheinbaum of Merchant Cash and Capital notes that clawbacks aren't used as often as some brokers might think. He says out of 800 deals in a 30- or 31-day period, his company enforces its clawback policy only a handful of times each month.

He also points out that while the clawback policy is on the books, Merchant Cash and Capital looks at each situation individually. If it's clear that the broker tried to defraud the funder, that's one thing, he says. But, if for instance, a merchant has a heart attack and dies 20 days into a deal and can't pay back the funds, Merchant Cash and Capital wouldn't try to claw back the broker's commission in that situation, he says.

Strategic Funding has only clawed back commissions once or twice in the past nine years, says Sederholt, the EVP.

The company works with a variety of brokers. Some have less than a 1 percent default rate and others have 12 percent to 14 percent default rates. As extra protection with brokers who have bad track records, Strategic Funding either declines to work with them at times, or has in place a stronger underwriting procedure with these deals.

Being more careful upfront is a better tactic than trying to go after commissions, which is extremely hard, Sederholt says.

### CHANGING THE MODUS OPERENDI

While it's not the industry norm, there are a few funders who have stopped using clawbacks, or are considering doing so, given all the headaches they can cause. Isaac D. Stern, chief executive of Yellowstone Capital LLC, a New York-based funder, says his company no longer tries to clawback commissions when deals go bust. The few times they tried to claw back commissions several years back,



the brokers they went after were upset and threatened not to do business with them anymore. Yellowstone decided this approach was bad for business and that it would be more prudent to try something else.

"There's too much competition, and if we were going to do clawbacks it would decimate our business," he says. "It's the broker's job to bring in the deals. It's our job to underwrite it. If something goes wrong on the deal, that's on us. It's not the broker's fault."

As protection, the contracts Yellowstone uses with brokers contain a provision allowing it to seek damages when fraud's alleged. But in cases where brokers send what seems to be a legitimate deal that goes bad for something other than fraud, Yellowstone turns the other cheek. Yellowstone can afford to eat the \$5,000 or \$6,000 commission to ensure ongoing—and hopefully more positive leads—or so the thinking goes, according to Stern.

Over time—if peer pressure continues to mount—it's possible that even more funders will decide chargebacks just aren't worth the trouble. "I think the reason why some funders are moving away from [clawbacks] is because people are afraid of losing volume. Once one funder acquiesces, others will follow suit," says Sheinbaum of Merchant Cash and Capital.



# MANUAL UNDERWRITING STILL DOMINATES IN TECH-BASED LENDING ENVIRONMENT

By SEAN MURRAY

## A summary of the underwriting panel discussions at AltLend

For all the talk that technology is changing the way people lend and borrow, the commercial side appears stubbornly reluctant to relinquish control to algorithms. At the AltLend conference in NYC, business lenders and merchant cash advance companies alike were mostly united on the idea that somebody needs to be double checking the computers.

“I like eyes on a deal,” said Orion First Financial CEO David Schaefer. He discussed why an entirely manual underwriting process had weaknesses however through an experiment he conducted years ago when he sent the same deal to six underwriters. “Three said yes and three said no,” he explained.

Like most of the others that spoke on the topic, Schaefer was in favor of a scoring model and he believes an automated underwriting system creates consistency when assessing risk. He was steadfast in his assertion though that humans had to be the last line of defense in fraud detection.

“We’ve got guarantors that have nothing to do with the business,” he said, offering an example of an applicant that was more than 80-years old, yet was passing themselves off as a hands-on construction worker.

“I’m still a big believer in the review and subjectivity,” he concluded.

Funding Circle’s Rana Mookherje expressed similar views. “[Humans] pick up things that an algorithm really can’t do,” he told the crowd.

“We have an experienced underwriter sitting there and calling every borrower that we give money to,” he added.

Mookherje said that their borrower profile differs from those that tend to use merchant cash advances.

For instance, their average client has been in business for 10 years, does \$2.2 million in annual revenue, and has 700 FICO. They also offer 1-5 year loans, whereas merchant cash advance transactions tend to be satisfied in under twelve months.

“If you need money in an hour, we’re not the right place for you,” Mookherje stated.

Funding Circle’s reliance on manual reviews may have to do with the loan terms being extended so long. Even Schaefer had said earlier, “I think it’s a lot easier to determine the behavior of a loan that’s less than twelve months as opposed to one that’s sixty months.”

But do other companies feel differently? Kabbage’s Alan





Reeves said that 95% of their customers are 100% automated since there are merchants who get stuck trying to connect their bank account in the online application process.

When Kabbage was asked over a year ago how much of a role computers should play in the underwriting of a deal, COO Kathryn Petralia responded, “Huge.” She also went on to say then that, “it is not going to be like the “Matrix” where machines are making all the decisions. You won’t see an underwriting world without humans.”

It’s ironic however that while Alan Reeves was introduced at the conference as the Head of Risk Analytics, both the printed agenda and his LinkedIn profile cite his title as being the Head of Manual Underwriting. It’s a telling title for a company that is often heralded as the pinnacle of automation and computational decisioning.

But why can’t lenders simply give in entirely to the machines? Mookherje said at one point that, “those that live and die by their underwriting are going to be the ones that survive.” And if that’s the



***WE’VE GOT GUARANTORS THAT HAVE NOTHING TO DO WITH THE BUSINESS,” HE SAID, OFFERING AN EXAMPLE OF AN APPLICANT THAT WAS MORE THAN 80-YEARS OLD, YET WAS PASSING THEMSELVES OFF AS A HANDS-ON CONSTRUCTION WORKER...***



case, then relinquishing control to the computers perhaps risks the chance of death if things don't work properly.

But humans, with all their natural flaws and imperfections pose the same risk. "Banks want to know that underwriting is consistent, that for any given customer, that you would underwrite them the same," said Sam Graziano, CEO of Foundation. "And it's not just having written policies and procedures," he added. "But having programs in place to ensure these policies are upheld."

The widespread dependence on humans to tie up loose ends in assessing risk may seem both practical and prudent, but to some traditional bankers, that system carries nightmarish implications.

Jim Salters, CEO of The Business Backer for example shared an experience his company went through years ago when trying to partner with a bank. Salters placed a high value on the manual review process, explaining that it was basically a strength of their core competency. The problem however, was that the bank said that would totally freak out their regulators.

The recurring message from the event's panelists was that banks not only want, but may actually require a firm credit model to make decisions. They need to be able to explain to regulators why some loans got approved and others got declined in a perfectly uniform and consistent manner.

Schaefer and Reeves were aligned on the importance of consistency in underwriting. You basically can't have a system where you arrive at three yeses and three nos on the same loan Schaefer explained.

But building an automated system and telling the humans to take a hike isn't an easy process. There's a high upfront cost associated with development and it can take years to generate statistically relevant conclusions. And a multivariate decline issued by an algorithm can potentially worsen the customer experience, especially if the customer asks for the

specific reason they were declined. Reeves said it can be difficult to explain to the customer that their FICO score was too low relative to their sales volume but that their FICO score on its own was good enough.

And yet once an automated underwriting system is developed, the cost of underwriting should drop significantly according to panelists. With that comes a decision consistency that the company can rely on and a system that bankers can get comfortable with.

But despite it all, Credit Junction CEO Michael Finklestein bluntly stated, "We're never going to approve a \$2 million loan with an algorithm."



**BANKS WANT TO KNOW THAT  
UNDERWRITING IS CONSISTENT,  
THAT FOR ANY GIVEN CUSTOMER, THAT  
YOU WOULD UNDERWRITE THEM  
THE SAME...**

The unifying concept that everyone seemed to agree on was that although credit models were undeniably important, human review would remain a complementary part of the process for the foreseeable future at least in the commercial finance space.

"At the end of the day, it all comes down to underwriting," said Mookherjee.

*Note: Quotes were sourced from several of AltLend's panelists and moderators. They were not necessarily spoken in the order presented or in response to questions posed here. I did my best to use them in the context of which they were said. The narrative viewpoint is my own.*



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