



## **FIRE DRILL IN ILLINOIS: BUSINESS FUNDING COMPANIES TARGETED IN REPRESSIVE BILL**

A Dialogue with David Goldin  
By Cheryl Winokur Munk

Tech-Friendly Business  
Finance Companies Make  
a Trip to Capitol Hill  
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## **FIRE DRILL IN ILLINOIS: BUSINESS FUNDING COMPANIES TARGETED IN REPRESSIVE BILL**

By ED MCKINLEY

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# Letter From the Editor

**BY  
SEAN MURRAY**

How can I possibly sum up the events that have occurred between this issue and the previous one? At the LendIt Conference, the excitement was still there but it had retreated from the blinding levels of sensational bliss it had exhibited in years past. That energy would only drop further in the weeks thereafter. Q1 reports showed a slowdown in originations at some of the industry's largest players. Then, of course, Lending Club announced their chief executive had resigned in what originally appeared to be a small scandal.

The timing couldn't have been worse because regulatory scrutiny was already starting to pick up. A controversial bill introduced into the Illinois State Senate was one of the first signs that the times are a-changin'. Several trade organizations have formed in 2016 to educate policymakers, an accomplishment that seemed almost impossible in previous years because of the competitiveness between rivals. And yet, there they were on Capitol Hill just recently, grouped together to tell their stories and explain the positive impacts they are having on the American consumer or small business.

The Internet will indisputably have a central role in how lending takes place in the future. But does that make the companies that provide loans over the Internet *online lenders*? Or will they just be lenders that are perhaps more tech-enabled or tech-dependent? Even banks are using technology and the Internet to interact with their customers. That makes naming the industry or sub-industries of which each company is a part of even more challenging these days. Are they online lenders? Marketplace lenders? Balance sheet lenders? Fintech companies? Crowdfunders? Peer-to-peer lenders? Non-bank funders? An identity crisis only makes advocacy more challenging, especially when distracting headlines are dominating the news. One can only imagine what a regulator must think.

Hopefully all becomes clear in due time.

—Sean Murray



# FIRE DRILL IN ILLINOIS: BUSINESS FUNDING COMPANIES TARGETED IN REPRESSIVE BILL

By ED MCKINLEY

Bankers and non-bank commercial lenders – two groups that often disagree – are united in their opposition to financial regulation proposed in Illinois. Both contend that if the state's Senate Bill 2865 becomes law it could choke the life out of small-business lending in the Land of Lincoln and might set a precedent for a nightmarish 50-state patchwork of rules and regulations.

Foes say the measure was created to promote disclosure and regulate underwriting. They don't argue with the need for transparency when it comes to stating loan terms, but they maintain that a provision of the bill that would cap loan payments at 50 percent of net profits would disrupt the market needlessly.









Opponents also regard the bill as an encroachment on free trade. “The government shouldn’t be picking winners or losers – the market should be,” said Steve Denis, executive director of the Small Business Finance Association, a trade group for alternative funders.

The states or the federal government may need to protect merchants from a few predatory lenders, but most lenders operate reputably and have a vested interest in helping clients succeed so they can pay back their obligations and become repeat customers, several members of the industry maintained.

“The ability to pay is really a non-issue,” noted Matt Patterson, CEO of Expansion Capital Group and an organizer of the Commercial Finance Coalition, another industry trade group. “I don’t make any money if a borrower doesn’t pay me back, so I don’t make loans where I think there is an inability to pay.”

Outsiders may find interest rates high for alternative loans, but companies providing the capital face high risk and have a short risk horizon, said Scott Talbott, senior vice president of government affairs for the Electronic Transactions Association, whose members include purveyors and recipients of alternative financing. Several other sources said the risks justify the rates.

Besides, a consensus seems to exist among industry leaders that most merchants – unlike many consumers – have the sophistication to make their own decisions on borrowing. Business owners are accustomed to dealing with large amounts of money, and they understand the need to keep investing in their enterprises, sources agreed.

In fact, no one has complained of any small-business lending problems in Illinois to state regulators, said Bryan Schneider, secretary of the Illinois Department of Financial and Professional Regulation and a member of Gov. Bruce Rauner’s cabinet.

Regulators should not indulge in creating solutions in search of problems, Sec. Schneider cautioned. “When

you’re a hammer, the world looks like a nail,” he said, suggesting that regulators sometimes base their actions on anecdotal isolated incidents instead of reserving action to correct widespread problems.

But the proposed legislation could itself cause problems by placing entrepreneurs at risk, according to Rob Karr, president and CEO of the Illinois Retail Merchants Association, which has 400 members operating 20,000 stores. “It would stifle potential access to capital for small businesses,” he warned.

Quantifying the resulting damage would present a monumental task, but a shortage of capital would clearly burden merchants who need to bridge cash-flow problems, Karr said. Shortfalls can result, for example,

when clothing stores need to buy apparel for the coming season or hardware stores place orders in the summer for snow blowers they’ll need in six to eight months, he said.

Restaurant owners and other merchants who rely on expensive equipment also need access to capital when there’s a breakdown or a need to expand to meet competition or take advantage of a market opportunity, Karr observed.

Capital for those purposes could dry up because just about anyone providing non-bank loans to small





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merchants could find themselves subject to the proposed legislation, including factoring companies, merchant cash advance companies, alternative lenders and non-bank commercial lenders, said the CFC's Patterson.

Banks and credit unions are exempt, the bill says, but a page or two later it includes provisions written so broadly that it actually includes those institutions, said Ben Jackson, vice president of government relations at the Illinois Bankers Association.

Trade groups representing all of those financial institutions – including banks and non-banks – have joined small-business associations in working against passage SB 2865. “The most important thing is to make sure we’re coordinating with the other groups out there,” the SBFA’s Denis contended. “Actually, Illinois was good practice for the industry in how we’re going to go about dealing with attempts at regulation.”

Patterson of the CFC agreed that associations should coordinate their responses to proposed legislation. “We’ve tried to gather all the affected players in the space and have dialogue with them,” he maintained.

Even though the various associations reacting to the bill generally agreed on principles, their competing messages at first created a cacophony of proposals, according to some. “There was a lot of noise, and I think we’ll all learn from that,” Denis said. “The industry has to learn to speak with one voice to legislators.”

Citing the complexity of dealing with 50 states, 435 members of Congress and 100 senators, Denis said everyone with an interest in small-business lending must work together. “If we don’t, we lose,” he warned.

Many of the groups came together for the first time as they converged upon the Illinois capital of Springfield last month when the state’s Senate Committee on Financial Institutions convened a hearing on the bill. The committee allowed testimony at the hearing from three groups representing opponents. The groups huddled and chose Denis, Jackson and Martha Dreiling, OnDeck Capital Inc. vice president and head of operations.

City of Chicago Treasurer Kurt Summers was the only witness who testified in favor of the bill, according to Jackson. The idea of regulating non-bank commercial lenders in much the same way Illinois oversees lending to individuals arose in Summers’s office, said an aide to Illinois Sen. Jacqueline Collins, D-Chicago. Sen. Collins serves as chairperson of the Financial Institutions Committee and introduced the bill in the senate.

Sen. Collins declined to be interviewed for



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this article, and Treasurer Summers and other officials in his office did not respond to interview requests. However, published reports said Drew Beres, general counsel for Summers, has maintained that transparency, not underwriting, is the main goal. Talbott has met with Sen. Collins and said she's interested primarily in transparency.

they maintained.

Politicians may view their support of the bill as a way of burnishing their progressive credentials and establishing themselves as consumer advocates, said opponents of the legislation who requested anonymity. "It's an important constituency," one noted. "No one is against small business."

After listening to testimony at the hearing, committee members voted to move the bill out of committee for further progress through the senate, Jackson said. Eight on the committee voted to move the bill forward, while two voted "present" and one was absent. But most of the senators on the committee said the legislation needs revision through amendments before it could become law, according to Jackson.

The legislative session was scheduled to end May 31. If the bill didn't pass by then it could come up for consideration in a summer session if the General Assembly chooses to have one, Jackson said. If it does not pass during the summer, it could come to a vote during a two-week "veto session" in the fall or in an early January 2017 "lame duck session." Unpassed legislation dies at that point and would have to be reintroduced in the regular session that begins later in January 2017, he noted.

Although time is becoming short for the proposed legislation, it's a high-profile measure that could prompt action, particularly if amendments weaken the rule for underwriting, Jackson said. The Illinois General Assembly sometimes passes important legislation during lame duck sessions, he said, noting that a temporary increase in the state sales tax was enacted that way.

Whatever fate awaits SB 2865, some in the alternative funding business have suspected that the

bill came about through an effort by banks to push non-banks out of the market. But cooperation among groups opposed to the proposed legislation appears to lay that notion to rest, according to several sources.

"I don't get that impression," Denis said of the



Support for the bill isn't limited to the Chicago treasurer's office. Some non-profit lending groups and think tanks back the proposed legislation, opponents agreed. The bill appeals to progressives attempting to shield the public from unsavory lending practices,





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IN THE SAME SPACE."***

allegation that bankers are colluding against alternative commercial lenders. "I think this shows banks and our industry can get together and share the same mission."

Talbott of the ETA also counted himself among the disbelievers when it comes to conspiracy theories against alternative lenders. "I'd say that's a misreading of the law and not the case," he said. "Traditional banks oppose this because it would effectively reduce their options in the same space."

The interests of banks and non-banks are beginning to coincide as the two sectors intertwine by forming coalitions, noted Jackson of the state bankers' association. A number of sources cited mergers and partnerships that are occurring among the two types of institutions.

In one example, J.P. Morgan Chase & Co. is using OnDeck's online technology to help make loans to small businesses. Meanwhile, in another example, SunTrust Banks Inc. has established an online lending division called LightStream.

At the same time, alternative funders who got their start with merchant cash advances and later added loans are contemplating what their world would be like if they turned their enterprises into businesses that more closely resembled banks.

And however the industries structure themselves, the need for small-business funding remains acute. Banks, non-banks and merchants agree that the Great Recession that began in 2007 and the regulation it spawned have discouraged banks from lending to

small-businesses. The alternative small-business finance industry arose to fill the vacuum, sources said.

That demand draws attention and could lead to bouts of regulation. Although industry leaders say they're not aware of legislation similar to Illinois SB 2865 pending in other states, they note that New York state legislators discussed small-business lending in April during a subject matter hearing. They also point out that California regulates commercial lending.

Many dread the potential for unintended results as a crazy quilt of regulation spreads across the nation with each state devising its own inconsistent or even conflicting standards. Keeping up with activity in 50 states – not to mention a few territories or protectorates – seems likely to prove daunting.

But mechanisms have been developed to ease the burden of tracking so many legislative and regulatory bodies. The CFC, for instance, employs a government relations team to monitor the states, Patterson said. The ETA combines software and people in the field to deal with the monitoring challenge.

And regulation at the state level can make sense because officials there live "close to the ground," and thus have a better feel for how rules affect state residents than federal regulators could develop, Sec. Schneider said.

Easier accessibility can also keep make regulators more responsive than federal regulators, according to Sec. Schneider. "It's easier to get ahold of me than (Director) Richard Cordray at the Consumer Financial



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Protection Bureau,” he said.

Also, state regulators don’t want to take a provincial view of commerce, Sec. Schneider noted. “As wonderful as Illinois is, we want to do business nationwide,” he joked.

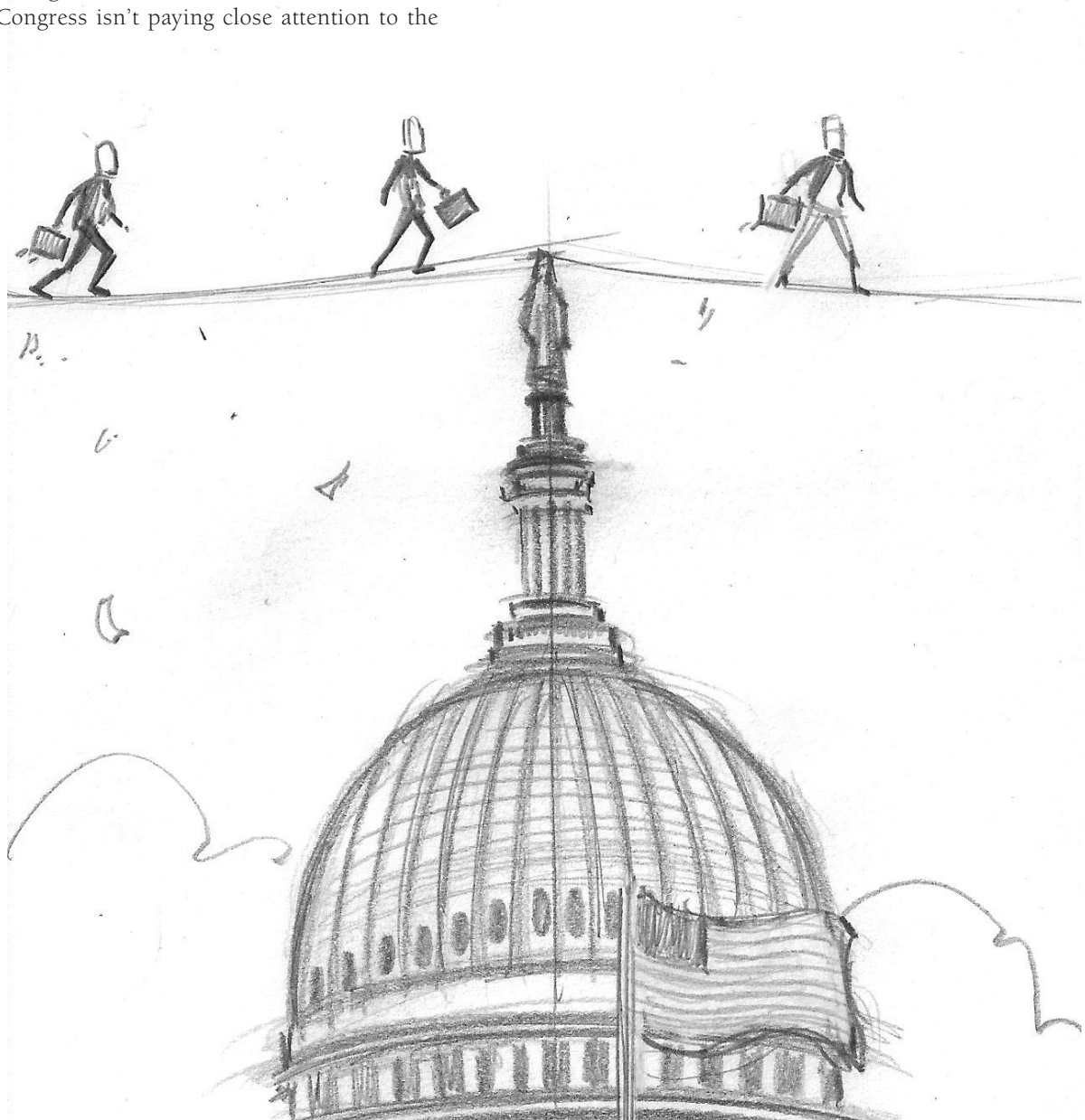
State regulators should do a better job of coordinating among themselves, Sec. Schneider conceded, adding that they are making the attempt. Efforts are underway through the Conference of State Bank Supervisors, a trade association for officials, he said.

At the moment, state legislatures and federal regulators have small-business lending “squarely on their agenda,” the ETA’s Talbott observed. The U.S. Congress isn’t paying close attention to the

industry right now because they’re preoccupied with the elections and the presidential nominating conventions, he said.

The goal in Illinois and elsewhere remains to encourage legislators to adopt a “go-slow approach” that affords enough time to understand how the industry operates and what proposed laws or regulations would do to change that, said Talbott.

At any rate, the industry should unite in a proactive effort to explain the business to legislators, according to Denis. “We need to work with them so that they understand how we fund small businesses,” he said. “That’s the way we can all win.”





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LendIt USA 2016 conference in San Francisco, California on April 12, 2016

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## DEBATED AT LENDIT:

# SHOULD MARKETPLACES HAVE SKIN IN THE GAME?

**Gilles Gade**, Cross River Bank **YES**

**Jeffrey Meiler**, Marlette Funding **NO**

**David Johnson**, First Associates **IT DEPENDS**

**Sid Jajodia**, Lending Club **YES**  
(but it depends on what skin means)

## THEIR EXPLANATIONS:

**Gilles Gade** said it's not only for the platforms but for the banks sponsoring the platforms to put loans on their balance sheet as well to qualify and perfect the status as true lender.

**Jeffrey Meiler** said that it shouldn't be a requirement but something you want to do because it's a superior value proposition.

**David Johnson** said that if we're talking about retail investors then skin in the game is very appropriate. If we're talking about institutional investors, then I don't think it's necessary.

**Sid Jajodia** said it depends on what "skin" means. From his perspective, if you don't deliver a value proposition to one side of the market, which is the investors, you don't have a market so there's inherent skin in the game by being a marketplace.





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DeBanked Magazine recently caught up with David Goldin, the founder, president and chief executive of Capify, a New York-based alternative funder. Goldin, who started his business in January 2002 as a credit card processing ISO, has been an outspoken and active participant in the alternative funding space since that time. He is also president of the Small Business Finance Association, the industry trade group that he helped found in 2006. The following is an edited transcript of our discussions.



**DeBanked: Continuing on the subject of growth, what do you think has been the most significant contributor to the company's upward progression over the past several years?**

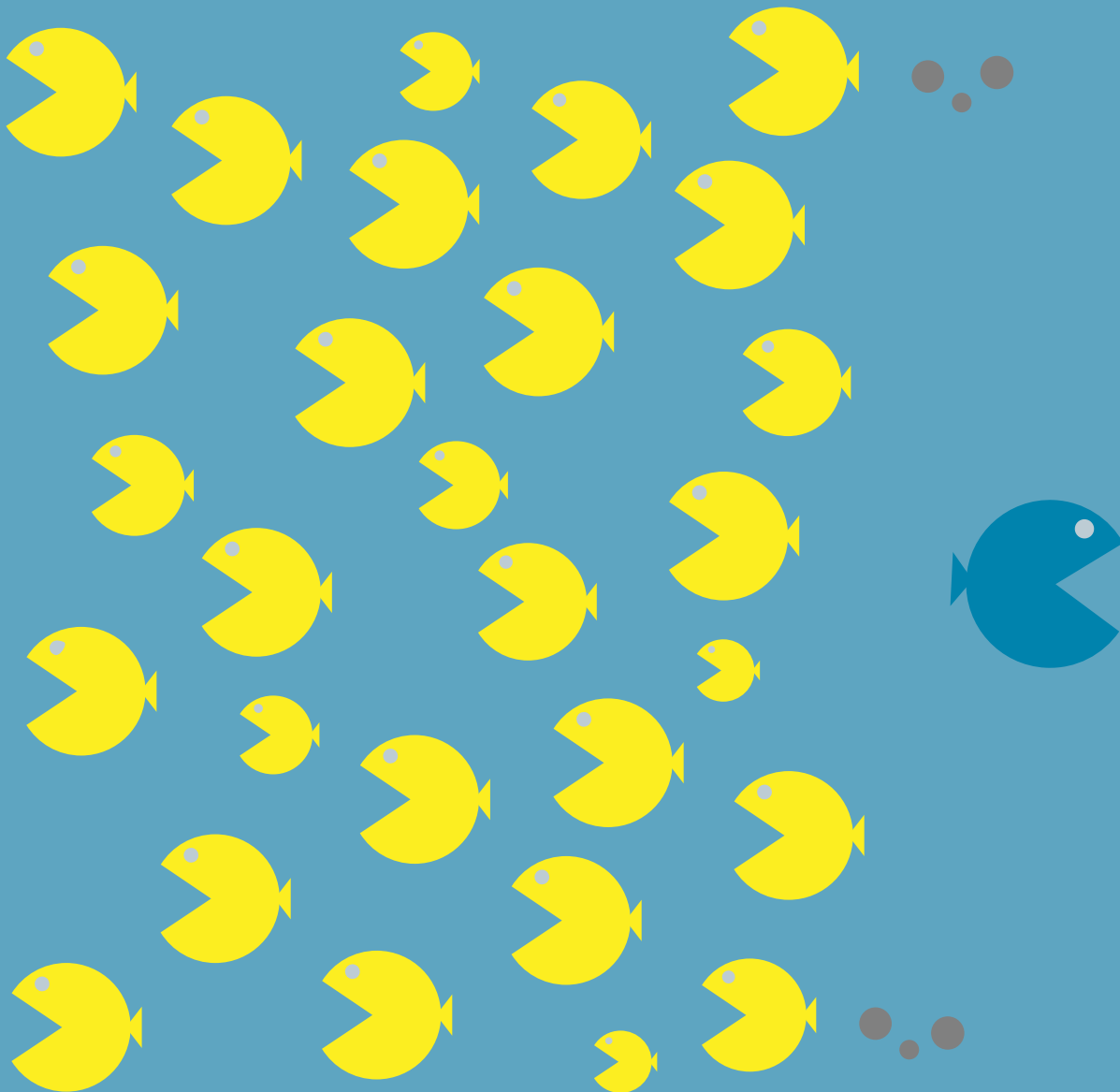
I think our underwriting model is what has helped us the most. Our performance data has allowed us to make decisions in tough times and automate our processes further based on historical trends. We have 10-plus-years of performance data in the U.S. and 8-plus-years overseas. Most companies have only three to five years of experience, and most importantly, they haven't been through an economic downturn.

**DeBanked: How has the competitive landscape in the industry changed in the past few years?**

Lenders are a different quality now. There is more variation in lenders than ever before—from lower-risk providers of capital to higher-risk providers of capital. Higher-risk providers of capital tend to charge a lot more. They also tend to have very aggressive business practices. The public perception is that all funders are the same—but we all have different business models and ethics in the way we operate our companies. It can be

**DeBanked: Since you started the business, Capify has grown from a credit card processing ISO into a global company with more than 200 employees in the U.S., U.K., Canada and Australia. Please talk a little about where Capify is today and your future growth plans for the company.**

The key here is responsible growth and the responsible providing of capital. Anyone can fund deals. The hard part is collecting the money back, so you have to know how to operate during a down economic cycle. Capify did it very successfully in the last economic downturn. As we move into uncertain times, it seems there's a greater possibility that the economy is going to get worse over the next 18 months. Even so, we're working on several new products and new partnerships that we'll be announcing shortly. Again, the trick is to be responsible about growth. We're staying laser-focused on our business right now and being very selective about where to invest capital in new projects during these uncertain times.



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challenging at times to help customers, the media, partners and investors understand the difference between Capify and less scrupulous players.

**DeBanked: What do you think the industry will look like in five to 10 years?**

I think you're going to see a lot of consolidation, and I think you're going to see a whole new variety of products being offered to customers. The customer acquisition cost is too high to only offer one type of product. Similar to banks, alternative funders are going to start offering multiple products, if they aren't already, and that will help make for a stickier customer and increase the bottom line.

Also, there will be significantly fewer funders than there are today and many ISOs will not be able to survive. I think more and more companies are going to start building their own internal sales forces. There are lower default rates and higher renewal rates in the direct model; the ISOs don't have skin in the game. I think some of the stronger ISOs over time will become part of the larger funding companies.

**DeBanked: There seems to be a consensus in the industry that more regulation of alternative financing is inevitable. How is regulation going to change how alternative funders operate and how might it change the competitive landscape?**

I think you'll see a lot more self-regulation before you see actual regulation when it comes to business-to-business lending. Funders are taking self-regulation more seriously and there have been more associations formed to educate policy-makers about the performance rates, default rates, renewal rates, customer satisfaction levels and how the products work.

The one area there could be potential regulation is in providing capital to sole proprietorships. The argument is that tiny businesses may need more assistance

than larger companies, and some make the argument that these micro businesses are quasi-consumers. We disagree. We feel that if a sole proprietor is using the capital for his business, it should be considered a business transaction. However, several factors—including rampant media attention, more publicly-traded alternative financing companies, tremendous growth of marketplace lending over the past several years and an election year—provide a recipe for all the regulation noise.

**DeBanked: What are the biggest risks our industry is facing right now?**

We've seen the movie before—in 2007 and 2008—when alternative funders didn't factor in the severity of how an economic downturn could affect their business. The risk is there again. Funders have to be even more responsible. It's not about how much you fund, it's about much you collect back. You can't be super-aggressive during times you think you may be going into a down period. There could be significant industrywide fallout from irresponsible underwriting.

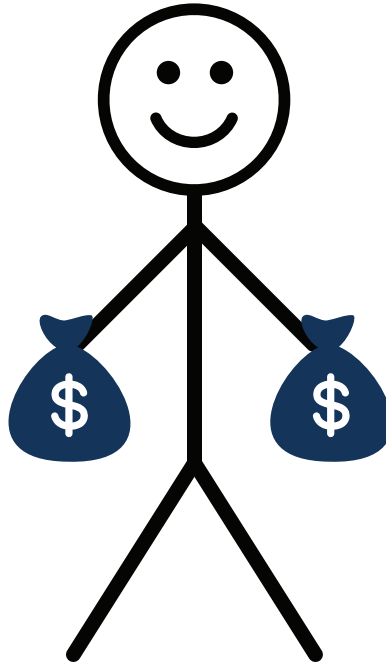
**DeBanked: What advice would you give to new funders entering the market now?**

I think the boat has left the dock; I don't think they will be able to compete with established players in a meaningful way. Someone who really wants to be in the business should look at acquiring several small to medium-sized companies and rolling them up to get scale. It would be very challenging and require many years of investment to start from scratch at this point to build a substantial company. It's harder now than it was in the past.

**DeBanked: Can you talk a little about where you see the future of banks and alternative funders and how they will work together?**

I think some banks will want to acquire platforms for

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speed to market or partner with platforms where the banks provide the capital and the funders service the loans. The latter is the model that J.P. Morgan and On Deck chose. The challenge is that the banks aren't going to

want to take a risk on applicants that don't fall within the certain credit profile that they are comfortable lending to.

While the partnership model will help banks make decisions faster about lending to small businesses, many small businesses will continue to be underserved. This could, in turn, provide an opening for

independent funders who are willing to provide capital, albeit at higher rates because you can't make a profit providing working capital (typically unsecured) at bank rates to the credit and risk profiles of businesses that most alternative funding companies work with today.

**DeBanked: Please address the major technology trends shaping the alternative financing industry and what this means for industry players?**

My opinion is the technology is ahead of the typical business brick-and-mortar business owner. While the technology exists for business owners to go to a website and provide their personal and business data, we have found most business owners want to speak with a salesperson first, get a comfortable level and then apply online. (Compared with going right to a website and applying without a human involved). However, each year that goes by more and more business owners get more comfortable with technology and a greater percentage of them will look

for a completely online experience. Being that it costs millions of dollars and years of time to build these platforms, you have to constantly evolve your platform to stay relevant. You can't just snap your fingers and have it up and running.

I think the trend for our specific industry is being technology-enabled rather than being pure-bred

tech companies.


Customers still want to speak to people, but you also have to have viable back-end technology so your business is scalable.

Technology, such as digital bank statement transmission via various platforms, also helps cut down

fraud compared with reviewing manual documents that can easily be forged or "Photoshopped."

**DeBanked: How can alternative funding companies best meet the challenges they are likely to face over the next few years?**

I think alternative funders need to focus on more responsible providing of capital. This means really focusing on business owners' ability to repay, taking a hard look at overburdening them with debt through stacking, for example, and further evaluating the referral sources of business they are getting their deal flow from in order to ensure that business owners get the best possible experience. Furthermore, I think as more alternative funding companies focus more on profitability and not just growth, coupled with the tightening of available institutional capital with an appetite for our industry, you will see some of the recent trends potentially reverse such as extremely high approval rates and industry margin compression.



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# TECH FRIENDLY BUSINESS FINANCE COMPANIES MAKE A TRIP TO CAPITOL HILL

By SEAN MURRAY





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The inability of banks to satisfy the demands of small businesses is not new, nor is it a problem purely borne out of the recession, data indicates. That's partially why the Small Business Administration (SBA) exists, according to a 2014 report co-authored by former SBA Administrator Karen Mills titled, *The State of Small Business Lending: Credit Access During The Recovery and How Technology May Change The Game*.

“The SBA has a portfolio of over \$100 billion of loans that lenders would not make without credit support,” according to Mills’ report. If that number looks big, it’s because it’s comprised mainly of loans made to the larger end of the small business spectrum. Smaller businesses or businesses with smaller needs anyway, continue to be underserved.

“Small firms were hit harder than large firms during the crisis, with the smallest firms hit the hardest,” Mills’ report states, but

Tom Sullivan, who leads the CRBF emphasized to deBanked that job creation plays a crucial role in what their organization represents and stressed that it was very important to get the input of small business owners when policymakers consider new regulations.

And OnDeck, who was on the Hill with the ETA, announced late last year that their first \$3 billion in loans have generated an estimated \$11 billion in US economic impact and actually created 74,000 jobs.

While the schedules and agendas of each group were different, the CFC reportedly met with nearly two-dozen House and Senate members or their staff in a single day.



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# WHAT HAPPENED WITH LENDING CLUB?

By SEAN MURRAY

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A recent scandal at Lending Club shook the entire world of financial technology. The resignation of Renaud Laplanche, the company's famous CEO and in many ways the face of peer-to-peer lending, was announced unexpectedly before the market opened on May 9th. In the hours and days to come, investors, platform users, analysts

and news media would judge them in the court of public opinion, sending Lending Club's stock price into a tailspin. Reporters at the Wall Street Journal were able to dredge out some of the juiciest details, alleviating some fears but raising even more questions.

While I have never held a position in Lending Club's stock, I have personally invested in notes on their platform, enough money in fact, to have experienced a sinking feeling when the news first broke. It was the kind of feeling you get when you're suddenly not sure if you've been duped all along.

The forged application dates on a batch of loans sold to investment bank Jefferies was probably the most serious offense that Lending Club copped to, though critics were no less outraged that Laplanche had not disclosed a personal stake in a venture that Lending Club invested \$10 million in.



Keynote Presentation by Renaud Laplanche, founder and CEO of Lending Club, at the LendIt USA 2016 conference in San Francisco, California, USA on April 11, 2016. Photo by Gabe Palacio

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The WSJ reported that Laplanche was given a 24-hour ultimatum on Friday, May 6th to resign after the Board of Directors felt that he had not been upfront about what he knew. Hours after his resignation was announced on Monday morning, the Department of Justice sent Lending Club a grand jury subpoena, stoking fear in the market that the issues just brought to light may have been criminal in nature.

As the drama unfolded, the hastiness with which prosecutors acted to convene a grand jury and serve a subpoena is uncanny. Consider that Lending Club's Q1 earnings report was originally scheduled to be released after the market closed on May 9th, but the details were published before 7:30 AM EST instead. The circumstances certainly warranted an expeditious announcement, especially if they wanted to make sure that they were the first ones to tell the world what had happened. The WSJ reported that Laplanche had been telling friends over the weekend that he had a new email address so any further delay in making his departure public risked another party leaking the news first.

But perhaps another factor (and this purely speculative theory is mine alone), is that Lending Club was set to be served with a grand jury subpoena on Monday regardless. That is unless you truly believe that the DOJ had dropped everything to convene a grand jury, draft a subpoena and send it out for service within hours of hearing the news.

If knowledge of a pending grand jury investigation had been discovered by Lending Club in advance, then that might better explain why their board showed Laplanche no mercy. How could they if things had already progressed to a level beyond their control? It would also imply something else, that someone blew the whistle on activities they didn't think were proper, which caused a grand jury investigation to begin with. Discovering that a public company had fudged data on a \$22 million loan sale would certainly be an action worth reporting to the authorities even if Lending Club later apologized and bought the loans back, which they did.

But even if the whistleblower theory is what really happened, it's probably better that events played out in the order that they did for the sake of the company and the industry they're a part of. The story is that Lending Club spotted a problem and resolved it on their own, a forgivable offense that may have hurt confidence but it hasn't destroyed them altogether, at least not yet.

Within a day, it was reported that big banks like Goldman Sachs had stopped buying the company's loans. That was to be expected given the news, a

pragmatic decision by a seasoned bank that is used to unpredictability in the market.

On the opposite side of the spectrum however, things were not so calm. Retail investors who buy tiny notes on the Lending Club platform for as little as \$25 each, reacted to the announcement by logging on to the Lend Academy forum to share thoughts, conspiracy theories, and feelings. "What did Laplanche know and when did he know it?" some users wondered. Others played Internet detective by looking at before-and-after screenshots of Lending Club's management team page to determine who was missing and what job titles had changed.

Veteran forum members tried to use reason and logic to downplay the risk of bankruptcy that panicked investors feared might be coming next. One such poll actually asked members to vote on whether or not they thought Lending Club would declare bankruptcy by the Fall. Most voted that it was unlikely to happen. And yet, the debate may not have been totally outrageous. At least one federal banking agency has been trying to assess the odds that a Lending Club bankruptcy might actually occur, according to a deBanked source.

For a retail investor on the platform like myself, the impact was immediately visible. LendingRobot, the robo-advisor I use to automate note purchases, was unable to spot any loans on the Lending Club platform that met my predefined filters for 11 straight days since Laplanche's resignation was announced. The void was spooky to say the least.

The big players were spooked too, it seems, because a consortium of 200 community banks suspended their purchases of Lending Club loans on May 12th.

On May 16th, the company announced that it may have to use its own money to fund loans in the event of an investor shortage.

And on May 18th, Lending Club was served with another subpoena, this time by New York regulators over usury concerns.

The seemingly never-ending stream of bad news did spark somewhat of a consensus among retail investors on the forum that Lending Club should consider implementing a Bankruptcy Remote Vehicle as part of a campaign to restore confidence.

As it stands now, a company bankruptcy could mean that platform investors could lose some or all of their investment, and here's why; While Lending Club is considered a marketplace, investors are not lending to borrowers through the platform. Instead, investors lend money to Lending Club and Lending Club works with a bank to make loans to borrowers. Therefore the credit risk is not just the borrower



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on every loan, it's also Lending Club's ability to survive as a company. And if enough people start feeding into the paranoia of a possible Lending Club bankruptcy, rationally so or not, well it's easy to see why signing up new investors would not be an easy task.

Lending Club rival Prosper Marketplace has minimized that risk for its investors thanks to a Bankruptcy Remote Vehicle (BRV) they put in place in 2012. Such a vehicle is an entity designed to protect the credit quality of assets from the underlying company. Some people predicted that Lending Club would respond to that move by setting up a BRV of its own in 2013, but they resisted. Now the chickens are coming home to roost.

In a nod to the company's crowdsourcing roots, retail investors on the Lend Academy forum began encouraging others to join in on making BRV demands to Lending Club. Many confirmed sending e-mails to that effect, but at least one user reported that he had "faxed" his demands directly to new CEO Scott Sanborn.

One can only picture that in the midst of all the chaos the company must be dealing with internally, what with the banks pulling back on hundreds of millions of dollars in investments, some 1980s fax machine in the CEO's office is printing out a letter from a random guy with maybe a few hundred bucks in notes demanding the formation of a Bankruptcy Remote Vehicle... or else.

But retail investors are no laughing matter. 20% of all loans issued by Lending Club in 2015 were funded by self-managed individual investors. That number increases to 47% when you include individuals who invest through investment vehicles or managed accounts. An unscientific poll on the Lend Academy forum that garnered only 38 responses suggested that 50% of investors had stopped investing on the platform as a result of the news, at least for the time being. That's not the kind of sentiment a lending marketplace can afford, even if it was just a friendly poll.

Back in March, a panel of industry CEOs that assembled at CommonBond's NYC office concurred that peers (AKA retail investors) would essentially be a safety net against the cyclical nature of the institutional capital markets. And if the reversion back to peer-to-peer lending roots was part of the end-game all along, well then the timing couldn't be any worse for Lending Club to lose faith from that crowd, the same crowd demanding immunity from their future bankruptcy via fax.

On May 23rd, it was revealed that a group led by Chinese billionaire Chen Tianqiao had upped its

stake in Lending Club to 11.7%, giving it significant influence in the company.

On May 24th, the US Solicitor General published a legal brief that argued that the US Court of Appeals for the Second Circuit erred in its ruling on *Madden v Midland*, reducing the odds that the US Supreme Court will hear the case, and diminishing the potential negative impact that the ruling could have on Lending Club's business model. The optimism would last for only a day.

On May 25th, the WSJ reported that a fund Lending Club controls had strayed from its intended parameters and bought riskier loans than it had intended.

What happened to Lending Club? Well, let's just say that May wasn't a great month for them. The issue now is whether or not they can rebuild trust and if they can't, or if they can't do it fast enough, then May will be a month that they and every company like them will never forget.

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*The Lend Academy forum mentioned in this article is an open website with user-generated content. Polls taken and opinions referenced from it do not necessarily reflect the opinions held by the owners or operators of the website. deBanked has no affiliation with Lend Academy. The accuracy of the information gleaned therein cannot be verified and is discussed here to try and characterize the point of view of retail investors as events unfolded.*

*The author and officers of this publication have never held a position in Lending Club's stock.*



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# ▶ LENDIT USA CONFERENCE SAN FRANCISCO

Photos courtesy of LendIt



Noah Breslow of OnDeck tells the crowd that partnering will be the dominant form of collaboration going forward



Fireside chat with Bloomberg's Emily Chang and famous entrepreneur Peter Thiel



From left to right: Sean Murray of deBanked, Kunal Bhasin of World Business Lenders, and Mark Cerminaro of RapidAdvance share a laugh in between sessions



Prosper's Ron Suber delivers what was said to be one of the conference's best speeches



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# A MERCHANT CASH ADVANCE ACCOUNTING

# Q&A

By YOEL WAGSCHAL, CPA

Below is a sample of Merchant Cash Advance topics that CPA Yoel Wagschal has covered at length on deBanked.com. To read the full version, visit: <http://debanked.com/2015/01/merchant-cash-advance-accounting-a-how-to-guide>

As a successful and knowledgeable Merchant Cash Advance accountant I often receive questions from MCA business owners and syndicators. In the last tax season, my accounting firm recognized that many of the questions we receive are distinctly similar. In the following article I address the most common questions my accounting office receives.

**Question: When I am accounting for my Merchant Cash Advance company isn't a cash advance accounted for in the same way as a loan? It looks the same on a spreadsheet so isn't the interest calculated in the same way as a normal loan?**

**Yoel Wagschal CPA:** No. Merchant Cash Advance companies do not have interest. If you have interest then what you have is a loan business, not a Merchant Cash Advance business. Loans use an entirely different method of accounting. If you are still accounting for your Merchant Cash Advances as loans with interest then you will have regulatory issues. If you tell an IRS agent that you are not a loan company but they see your books are exactly like a loan company, how do you think that will end for you? Loans and interest are in a different world. You are the last person who wants to combine those two worlds. You need to see how they do their books at an accounts receivable factoring company and model yourself after them. They do it the way my accounting firm presents it.

**Question: Your article mentions two ways in which Merchant Cash Advance Companies can account for transactions (cash basis and accrual). Are those the only two ways in which my accounting can be processed?**

**Yoel Wagschal CPA:** I guarantee you would have a big argument if you brought 100 accountants together and asked them all this question: How do I recognize revenue in an accrual basis (from a GAAP standpoint) if I am allowed to take the entire income this year? You would have all kinds of voices and differences of opinions because there is no guidance for this industry. I have done the research and structured an accounting methodology. I've spoken with the biggest firms and dealt with the biggest names in this industry. I do have a passion for MCAs. When it comes to a tax standpoint, if you file a cash basis and you want to minimize your exposure, there is really only one way to do it. Those two ways (cash and accrual) can be kept so that they are converted from one to the other at the end of the year. Hence, if you want to prorate the income portion of your receivable (cash basis) I would still keep the books on accrual then convert it at the end of the year. You could do this with a single journal entry because it simplifies the bookkeeping process. You end up with an accrual basis financial statement and a cash basis tax return.

**Question: When my company advances funds to a merchant how do I account for this? Also, how do I account for my company's income with cash basis (tax return)?**

**Yoel Wagschal CPA:** Ok, we know that in cash basis accounting we don't recognize revenue before it is actually received. For instance, a grocery store that lets a customer take an order on credit doesn't recognize revenue at that point. Income is recognized when funds come in.

Now we will think about the Merchant Cash Advance industry. Let's start with when you advance funds to a merchant. For this example you



advance 100k to a merchant and the payback is 140k. The 100k you send to that merchant should not be expensed. That 100k should stay on your balance sheet. You don't recognize any income because you haven't collected any income yet.

At the end of the year we have collected half of the advance. It started with 100k funded and 140k to collect. Now we have collected 70k. The most rational way to decide which part of the 70k goes down on the balance sheet and which part should be recognized as income is to prorate it. You should show that half has been collected which means that half of your income should be recognized now. We show it now because you have, in fact, collected revenue.

**Question: For cash basis (tax return) purposes, when do we realize a loss? How do you show and what do you call the write off of uncollectible merchant cash advances?**

**Yoel Wagschal CPA:** This is a very good question. There are some weird things going on in this industry because normally in a business you don't exchange money to make money. On a cash basis tax return you would not see a receivable on the cash basis balance sheet. Concurrently, you would not see any bad debt.

Bad debt is usually not something that you see on a cash basis tax return. However, if you really look at the IRS regulations they do understand that even in a cash basis business there are bad debt expenses. Why wouldn't you usually see bad debt expense? It is because you never recognize any income from the money you didn't receive. Even with a cash basis tax payment, when a taxpayer lends money to a vendor (in a 'normal business situation') and that vendor doesn't pay the taxpayer back, we know the taxpayer is entitled to take a bad debt expense. In the Merchant Cash Advance situation, where we exchange money to make money, what could

be more of a 'normal business situation'? This is how your business works so if a merchant does not pay you back then you are entitled to a bad debt expense (of course, the actual realizable cash loss). This bad debt expense gets realized when the Merchant Cash Advance company is certain they are not going to get paid. In the rare situations where you have already written off a bad deal and the merchant does end up paying, you will need to reduce your bad debt expense for the following year or you can add it to your income for the following year.

As far as labeling, I believe the IRS wouldn't care what you call it. I understand why you want to label it differently. The truth is that this comes only out of the fear that an amateur might look at it. A real trained knowledgeable professional will understand it. Bottom line is, it is perfect (although not normal) for a cash basis taxpayer to have a bad debt expense. But, you can see nothing here is the norm. So do we care for the amateur or for the expert?

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*Read a more comprehensive guide at:*

**<http://debanked.com/2015/01/merchant-cash-advance-accounting-a-how-to-guide/>**

*or contact Yoel Wagschal at:*

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