Legal Loansharking:
A Dive into the Merchant Cash Advance Industry

by

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I. Introduction

This paper focuses on the merchant cash advance industry, which utilizes technology to fill a gap in the financing market caused by financial regulations. The merchant cash advance is a form of financing for small businesses that usually have no other means to borrow money. This is an under-the-radar industry, largely overlooked by academia, media, and government and as a result has virtually no regulation. As you will read in this paper, this has led to shady practices, fraudsters making millions, and the bankruptcies of thousands of small business across the United States. Most lenders in this industry are privately-owned and take great measures to keep their information a secret – there is little public data on this industry. In this paper I detail the origins of the merchant cash advance, demonstrate how and why this industry is exempt from regulation, explain the math behind it, discuss if the industry is beneficial or harmful to the borrower and overall market, and explore how regulation can and should impact the industry.

II. Payday Loans: The Predecessor

A payday loan is a loan made to an individual in need of quick cash. It is usually short-term, with repayment typically within a couple of weeks from origination. These loans are unsecured and usually given to subprime borrowers who may have low or no credit score and would likely be denied a loan from a traditional bank. They carry high interest rates called "fees" that range from $10-$30 for every $100 borrowed. For example, if a person borrows $100 with a $15 fee and pays it back in two weeks, this is the equivalent of 400% annual percentage rate (APR). To put this into perspective, the average 30-year fixed-rate mortgage for a house is under 3% APR[1] and the 10-year US Treasury rate is approximately 1.6%.[2] In its heyday, payday

[1] "Current Mortgage Rates: Compare Today's Rates | NerdWallet."
[2] "TMUBMUSD10Y | U.S. 10 Year Treasury Note Price & News - WSJ."

lenders would use illicit and misleading tactics to convince borrowers who could not afford to repay their debt to borrow a new sum of money as part of a "refinancing". It is common for the lenders to pressure the borrowers into taking new loans, each incurring additional fees. Combined, these two effects create a debt spiral that can trap consumers and make it difficult to ever pay off the loan entirely. In 2011, the *Dodd–Frank Wall Street Reform and Consumer Protection Act* authorized the creation of Consumer Financial Protection Bureau (CFPB) which began to regulate payday lenders. The Bureau ensures that payday lenders cannot mislead, harass, or pressure consumers into taking additional loans. In addition, 28 states have passed laws that either cap the maximum interest rate a lender may charge (called a usury law) or banned payday lending outright.[3] Overall, the payday loan industry is an $11 billion market in the United States in 2021[4] and is largely subject to regulations at the state level and has consumer protections from the CFPB.

III. Merchant Cash Advance: Explained

The merchant cash advance (MCA) is essentially a payday loan for a business. A business will receive a lump sum of capital and will pay back a multiple of that amount with automatic daily deductions until it is paid off. These loans are typically collateralized by accounts receivable. These loans are generally short-term, with little paperwork involved, and the money is received in as fast as 24 hours. The typical firm taking an MCA is a small-to-medium sized business that is a subprime borrower, typically paying a much higher interest rate than a typical business loan. It is estimated that in 2016 MCA borrowing summed to around $10 billion, with a default rate up to 600% higher than loans from the U.S. Small Business

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[3] "Legal Status of Payday Loans by State."
[4] "IBISWorld - Industry Market Research, Reports, and Statistics."

Administration.[5] Many borrowers find the MCA to be a last resort option, if they are unable to get a loan from a bank and because "cheaper loans backed by the Small Business Administration are tough to get and can take months to close."[6]

In order to quantitatively demonstrate how the math behind an MCA works, the following is a table that breaks down a hypothetical MCA. As shown, the borrower will receive a lump sum of $10,000. The borrower will owe an amount larger than the amount received. This figure will be equal to the advance amount times the *buy rate*, also known as the *factor rate*. In this example, the borrower will repay $13,500 because the buy rate is 1.35x on $10,000.

Hypothetical MCA Example	
Advance Amount	10,000
Buy Rate	1.35x
Payback Amount	13,500

The terms of the MCA specify how the advance will be repaid. Unlike a traditional loan, the borrower does not pay the lender in fixed amounts. Instead, the borrower repays the MCA with automatic electronic payments. More specifically, a designated percentage of daily, weekly, or monthly credit card sales will be directly sent to the MCA provider until the borrower pays the entire payback amount. Notice how words like "interest rate," "debt," or "loan" are not used to describe an MCA. This is because an MCA is classified as an "advance" rather than a "loan." Even though a loan and an MCA both involve receiving a sum of money that must be paid off, regulators do not consider an MCA a loan. MCA insiders argue "they aren't actually charging interest—they're buying the money businesses will make in the future, at a discount."[7]

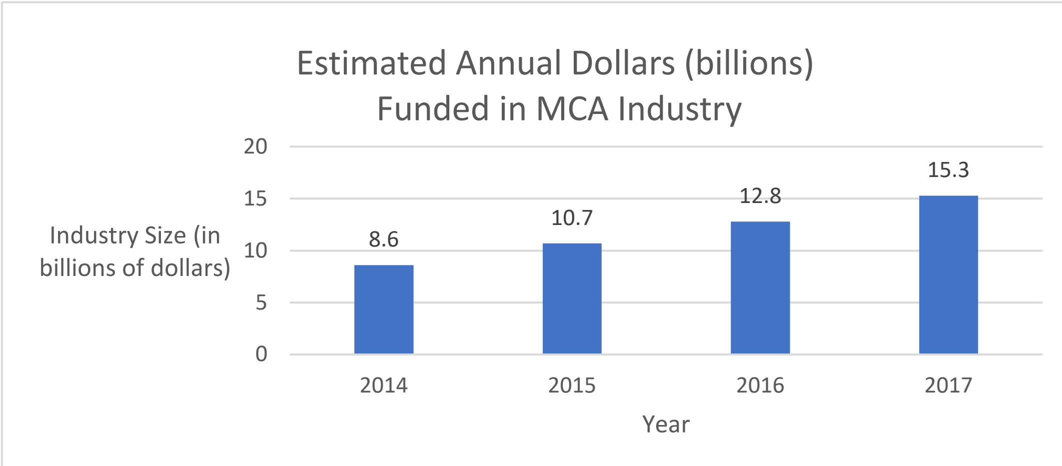
[5] "BPC-MCA-SMB-Financing-Industry-Report.Pdf."
[6] "OnDeck IPO: Shady Brokers Add Risk in High-Interest Loans - Bloomberg."
[7] "How Two Guys Lost God and Found $40 Million - Bloomberg."

Although it seems like a pedantic distinction, by not being classified as a loan MCAs are avoid the laws and regulations that are associated with lending. For example, banks that lend are subject to Dodd-Frank and Basel III, whereas MCAs are able to skirt these regulations, which include capital and disclosure requirements.[8] In addition, MCA providers are not subject to usury laws, which act the limit the maximum percentage of interest that can legally be charged. Remember that payday loans (to individuals) were deemed predatory, and as a result became subject to stricter financial regulation. This has not happened for the MCA industry, despite being a larger industry in terms of dollars. In sum, MCAs are not considered loans, so they are not subject to those regulations; usury laws do not apply to MCAs and there are virtually no regulations on MCAs. Therefore, MCA providers can legally charge whatever APR equivalent they desire without disclosing it to the borrower. This has been proven in court as recently as 2018. *Champion Auto Sales, LLC et al. v Pearl Beta Funding, LLC* in the state of New York found (in a unanimous decision) that MCA lending in excess of the usurious limit is permitted.[9]

The following graph shows the size and fast growth of the MCA industry. The MCA industry is a small percentage of the overall lending in the United States and the world. However, the outcomes of these loans have real effects on real small businesses and real people. It is estimated that payday lending (which can be thought of as MCAs for individuals instead of small businesses) is an $11 billion industry. That industry is subject to usury laws, and its borrowers are protected by the Consumer Financial Protection Bureau. This is an example of an industry

[8] "Paskelian and Bell - THE TALE OF TWO REGULATIONS — DODD-FRANK ACT AND B.Pdf."
[9] "It's Settled, Merchant Cash Advance Not Usurious | DeBanked."

that became regulated because it was deemed predatory. In contrast, the MCA industry is an even larger industry, at $15.3 billion in 2017, and is almost entirely an unregulated industry.

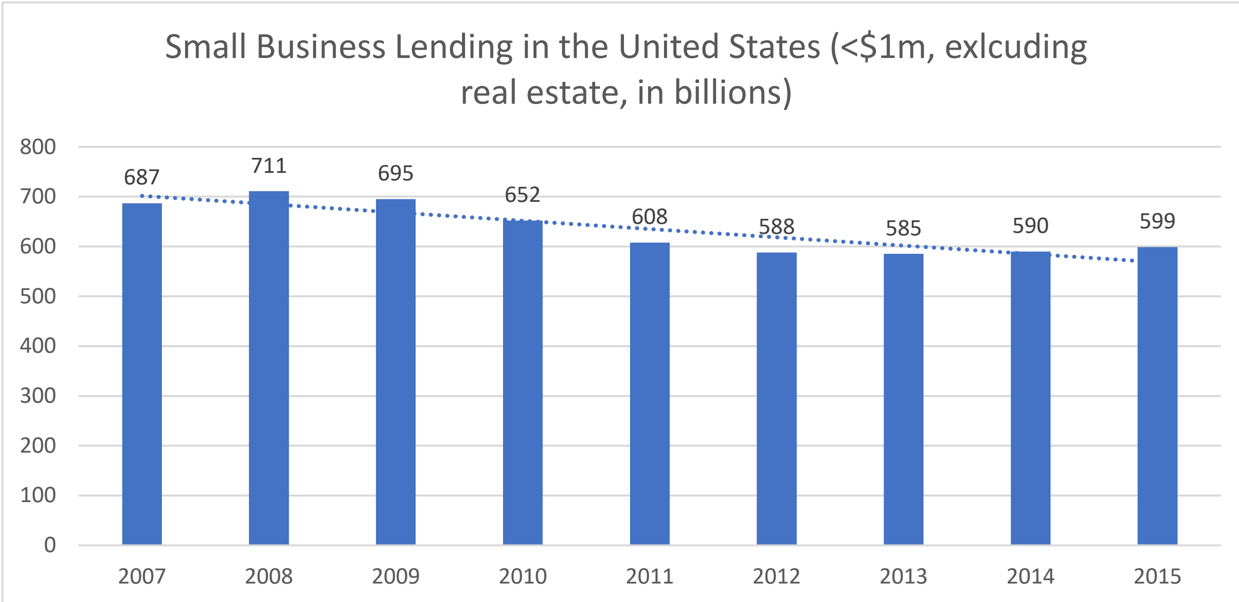


IV. The History of the Merchant Cash Advance

The merchant cash advance industry is relatively new. MCAs are only possible with the advent of digital payments. Credit cards became widespread in the 1990s, and the MCA industry closely followed. It is believed that AdvanceMe in Georgia became the first MCA provider in 1998. These MCAs required a personal guarantee. In other words, if the business was unable to repay the advance, the individual would be responsible. It is uncommon for the modern-day MCA to involve a personal guarantee.

Originally, AdvanceMe had a patent on MCA technology, which meant it was the only provider at that time. In 2007, a Texas judge invalidated AdvanceMe's patent on cash advances against future credit card transactions, allowing new MCA firms to compete. Within the next year, the 2008 crisis and following recession greatly changed the financial system. Firstly, banks as a whole became more reluctant to underwrite loans. Loans were risky, and after the housing and financial system collapse, banks were risk averse. Secondly, the banking system saw consolidation. Large banks absorbed many smaller regional ones. Between 1998 and 2015, the number of large banks increased by 32% and the number of small banks decreased by 38%. Small regional banks have traditionally been, and still are, more willing to lend to small and medium sized businesses, as compared to large, multinational banks. Historically, big banks approve roughly 22% of small business loans, compared to small banks approving 49%. The effect was twofold: banks reduced lending to small businesses overall due to uncertainty in the economy, and small banks which are more likely to lend to small businesses were replaced with large banks. Experts believe that regulations and compliance costs disincentivize big banks from lending to small businesses because the regulatory costs are not worth the small dollar amount loans. For a small bank, the dollar amount of a small business loan is more meaningful to the bottom line of the firm.[10] The aftermath of the financial crisis led to more regulations, exacerbating this issue. Legislation like Basel III and Dodd-Frank made the financial industry more cumbersome, which to some extent reduced small business lending. Overall, small business lending (which is defined as business loan less than $1 million) has declined throughout the United States over the past decade. This represents more than a 12% decrease in small business lending from 2007 to 2015. As a result of these changes, many small businesses were unable to obtain a traditional loan from a bank. The need for financing still existed, so small businesses were forced to look for alternative ways to borrow money. This led to the merchant cash advance becoming more popular.

[10] “BPC-MCA-SMB-Financing-Industry-Report.Pdf.”



V. Origination

Merchant cash advance providers source their clients in one of two ways, each making up around half of the advances in the industry. The first is directly, meaning their internal marketing team will find merchants in need of an advance. The second is through an Independent Sales Organization (ISO). Both methods involve cold calling and sending spam faxes to small businesses.

The ISOs will charge the MCA provider a one-time commission, usually around 5-10% of the advance amount. In order to cultivate relationships with the ISOs and increase the number of leads they receive from them, MCA providers sometimes allow ISOs to invest in a portion of a merchant cash advance that they source. This means that the ISO will contribute capital (usually a maximum of 50% of the advance amount) and become an investor in the deal. The MCA provider will service and collect the advance and pay the ISO its share. However, because of this passivity and relying on the MCA lender to realize a return, some legal scholars believe that this aspect of MCA may fall under the jurisdiction of federal securities laws. Law firm

Troutman Pepper opines that "In *SEC v. WJ Howey Co.*,[2]> the U.S. Supreme Court established the following four-factor test for identifying the existence of a security: (1) an investment, (2) in a common enterprise, (3) with a reasonable expectation of profits, (4) to be derived from the entrepreneurial or managerial efforts of others."[11] The bottom line is that this is not settled law. The merchant cash advance industry is young, and the intricacies of the legal aspect have not been decided. There exists a chance that as the industry is around for more time, regulators will examine it more closely, and more regulation will be added. Merchant cash advance providers rely on third-party financing in order to originate advances and conduct operations. It is possible that the way many of these firms obtain financing will be deemed illegal under federal securities regulations for violating the Howey test.

As part of the underwriting process, MCA providers conduct a due diligence. This may involve analyzing bank statements, monthly credit card sales volume, the age of the company, and the rent-to-sales ratio. It is not uncommon for an MCA provider to mandate the business use a particular point of sale (POS) terminal that will account for and automatically remit the payments to the MCA on a daily, weekly, or monthly basis. Merchant cash advances do not heavily rely on FICO credit scores or the credit of the merchant. In fact, many small business owners decide to take out an MCA only when every other type of lender has denied their request.

VI. Debt or Equity?

In traditional corporate finance, a firm can decide between debt and equity for their financing needs. However, MCAs are distinct from both. In one sense, the company borrows capital, and must repay with interest, similar to debt. However, MCAs resemble equity in the

[11] Dabertin 1 and Nowak, "Merchant Cash Advance Participations and the Federal Securities Laws | Lexology."

sense that repayment is tied to future firm performance, almost like a dividend –the capital is repaid on future revenues, and if the firm defaults, the MCA lenders do not get repaid, resembling an equity investment.

MCA firms are not technically classified as lenders according to the law. Instead, they argue they are buying the rights to the future receivables of the firm. As a result, if the firm finds that it cannot pay back the loan or that the repayment on each transaction becomes too high, it is often more desirable to cease operations so that there are no more future receivables. And since it is not debt, the "lender" has no claims to the assets during bankruptcy or liquidation. One of the biggest advantages of traditional debt is that debtholders are the first to be paid back during liquidation or bankruptcy, which is not the case for MCAs. Therefore, MCAs are riskier than debt, which means lenders need to be compensated accordingly.

	Debt	**Equity**	**MCA**
Ownership Interest[12]	No	Yes	No
Interest Payments	Fixed or floating, usually not contingent on borrower's financial state	Dividends, usually contingent on borrower's financial state	Automatic payments as a percentage of daily/weekly/monthly credit card sales
Right to influence borrower?	Only in default	Voting rights	Usually no
Claim on assets in bankruptcy?	Senior claim	Last, after all creditors paid	Usually no
Secured on assets?	Sometimes	No	Secured on accounts receivable
Fixed term length?	Usually	N/A	No

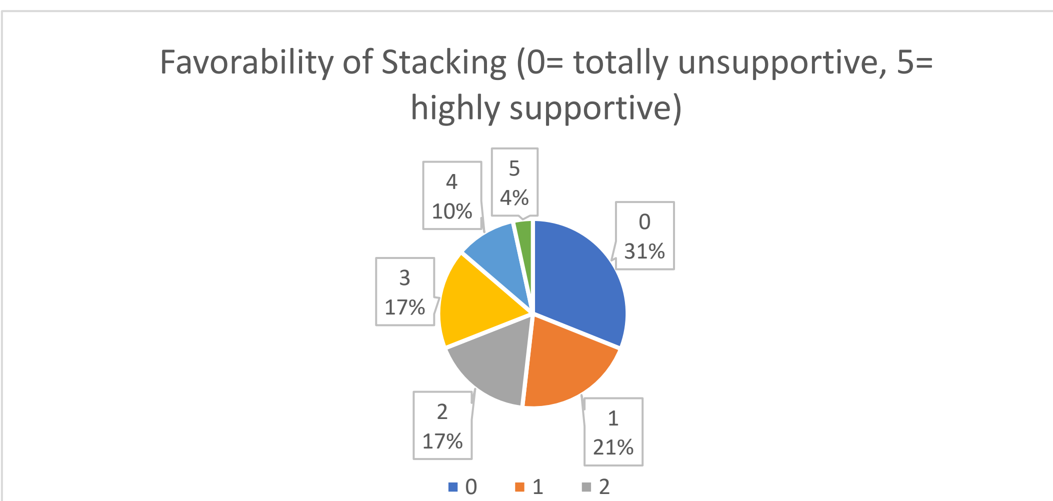
[12]Table adapted from "Classifying Funds: The Type of Contract – Is It Equity or Debt? | Simon Taylor's Blog."

VII. The Debt Spiral

It is commonplace in the industry to take out additional MCAs on top of an initial advance. This is known as “stacking.” Similar to the payday loan industry, it is common to borrow additional money if the borrower is unable to pay the initial debt. Both the payday loan and MCA industry have been known to use deceptive practices to convince borrowers to take out additional sums of money. It is a controversial practice among MCA providers. MCA providers may approve a small business to take an advance of a certain amount, which is often more than the business can afford to pay back. Since they cannot afford to pay it back with their own income, they persuaded by the MCA provider to borrow more money to “refinance”. This creates the debt spiral where the debt becomes insurmountable. For example, if a small business takes out three MCAs each with taking 10% of their credit card revenue, and the business’s margins are only 20%, the business will lose money on every sale. The following table shows a hypothetical business that has constant monthly revenues of $20,000 that takes an MCA in months 1, 4, and 7, each with repayment of 10% of revenue. In the first three months with just one MCA, the business remains profitable. In the middle three months with two MCAs, the business is breakeven. In the final three months, now with three MCAs, the firm has negative profits. This is because it pays 30% of its monthly revenues (10% for each of its three MCAs), and has net margins before repayment of only 20%

	One MCA			Two MCAs			Three MCAs		
Month	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**
Revenue	20000	20000	20000	20000	20000	20000	20000	20000	20000
Net Profit (before MCA)	4000	4000	4000	4000	4000	4000	4000	4000	4000
MCA Payment	-2000	-2000	-2000	-4000	-4000	-4000	-6000	-6000	-6000
Profit	2000	2000	2000	0	0	0	-2000	-2000	-2000

One MCA provider, Elevate Funding, has a strict no-stacking policy. This firms reasons that stacking puts a "strain on your cash flow and available daily balances" and that it creates a "slippery slope" for small business owners to take out more and more money that they cannot afford to pay back.[13] However, this is far from the unanimous opinion of all MCA providers. The following graph shows the favorability of stacking of CEOs of MCA providers. As shown, only 31% of MCA providers are "totally unsupportive" of stacking, meaning 69% support stacking to at least some extent.



[13] "What Is MCA 'Stacking' and Why We Discourage It?"

Some MCA providers encourage stacking because they are able to collect fees on each advance. This creates a moral hazard, where the salespeople originating MCAs collect their fees, regardless if the borrower is able to pay back the advance or financially survive. This allows the originators to encourage riskier borrowing, since they face no consequences if the borrower goes bankrupt as a result of the MCAs. There is no required license, training, ethics guidelines, or regulation associated with becoming an MCA broker. In fact, the only training for newly hired brokers one MCA provider World Business Lenders provides is from sales veteran Bryan Herman. Herman was charged with fraud in 1998 after starting his career at Jordan Belfort's Stratton Oakmont, which was depicted in Martin Scorsese's 2013 film *The Wolf of Wall Street.*[14] Although deceptive practices are common in selling MCAs, many brokers all well-intentioned but are nevertheless misinformed about the product they are selling, and as a result, pass that incorrect knowledge onto the borrowers.

VIII. Illustrative Merchant Cash Advance Narrative

The following example is hypothetical but is similar to many true stories of a small business taking a merchant cash advance.

Bill owns a hardware store at the center of his mid-sized town in New York state. This store has been his family's only source of income for three generations. Although the business had been in decline for the past few years, Bill had always found a way to make ends meet and never borrowed money from a bank. However, the store's financial condition worsened as a result of the COVID-19 pandemic. Despite taking a Paycheck Protection Plan (PPP) loan, the

[14] "Wall Street Finds New Subprime With 125% Business Loans - Bloomberg."

store could not cover its operating expenses. Faced with the decision to either borrow money or close shop, Bill decided the former was a better option.

Bill's local bank chain had been replaced with a Chase bank several years prior. Bill applied for a loan for his small business. A few days later, his loan application was rejected, largely because he had no credit history. Bill thought there was no way for him to borrow the money he needs to save his business and had given up hope. Bill saw an opportunity in a billboard ad that claimed to lend small businesses money, even with no credit history.

Bill called the number on the advertisement, and the man on the phone told him that his firm does not offer a loan, but rather an advance. More specifically, a merchant cash advance. This would give Bill's hardware store $50,000 to survive the economic downturn. Rather than paying the loan back with equal payments over a predetermined time period with a set APR, the MCA terms specify a buy rate. The man told Bill that his buy rate would be 1.3 and that payments would be made automatically as automated clearing house (ACH) payments daily as a flat 10% of his credit card sales each day. The man told him he would get the money into his business account in just 24 hours. Bill did not understand the fine print of the deal nor what a buy rate is, but he saw it as the only way to save his business, so he happily agreed to the deal.

The next day, the money was deposited into Bill's account. At first, Bill was happy with his MCA. However, each month his expenses remained higher than his revenues, which were now 10% lower because of the MCA repayment. Bill's landlord refused to lower his rent, and Bill could not reduce his workforce any more than he already had. Each month, Bill used some of his advance to cover his excess expenses. After three months, the $50,000 was gone. At this point, his expenses still exceeded his income. However, Bill was worse off than he was before, because in addition to this problem persisting, he now was still paying 10% of his daily revenue as repayment. Bill returned to Chase bank to apply for a small business loan but was rejected once again. Having nowhere else to turn, Bill went to a different MCA firm and took another advance. This time, Bill took out another $50,000 advance to cover his operating expenses for the next few months. He figured he would borrow again to help his business survive until he was profitable, which he thought would be soon.

He was offered the same factor rate of 1.3, this time with 20% daily payments. Bill still did not understand what these terms meant, but he did know that he needed to borrow more money or else his hardware store would go out of business, like so many others in his town. As discussed, this is known as stacking MCAs.

Now, Bill is losing 10% of his revenue to repay the first MCA, and 20% to repay the second. He cannot even repay his first MCA with the second, because Bill found out that a 1.3 factor rate on $50,000 means he owes $65,000 on the original, and the same amount for the second MCA. Bill owed a total of $130,000 in exchange for receiving $100,000. Furthermore, Bill must pay 30% of his daily revenues to remain in good standing with his MCAs. However, Bill's profit margins are well under 30%, so he actually loses money on every sale at the store his grandfather founded. He explained his case to the bank, which once again rejected his loan. Even though Bill had made every payment on time for his MCAs, it did not have an effect on his credit score.

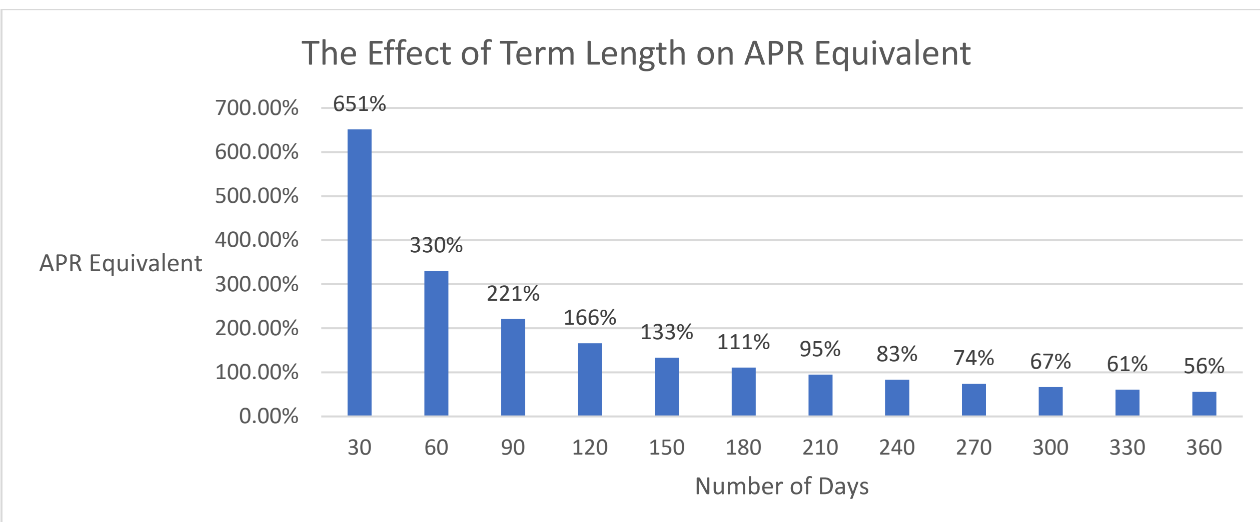
Bill had entered a debt spiral – the only way to pay off his debts are to take out new debt, which is unsustainable and would only put him in more debt. He realized that he would never be able to repay the debts and he could not afford to lose money on every sale. After sixty years in business, the hardware store shut its doors.

Now imagine that Bill's first MCA provided him enough working capital to survive. He paid his employees, bought more inventory, and paid his rent. However, at the end of the month, Bill realized that his store had lost money. As agreed, the firm that had given him his MCA had taken 10% of his revenue every day that month. Bill's profit margin was narrow before his MCA, so losing ten cents on every dollar sold seriously reduced his bottom line. Nevertheless, the MCA allowed Bill to weather his financial hardship, and after around three months, the firm stopped taking their 10% -- he had fully paid off his MCA. Bill was happy. Yes, those months had been difficult because of the reduced profits from paying back the advance. However, it was a small price to pay compared to going out of business.

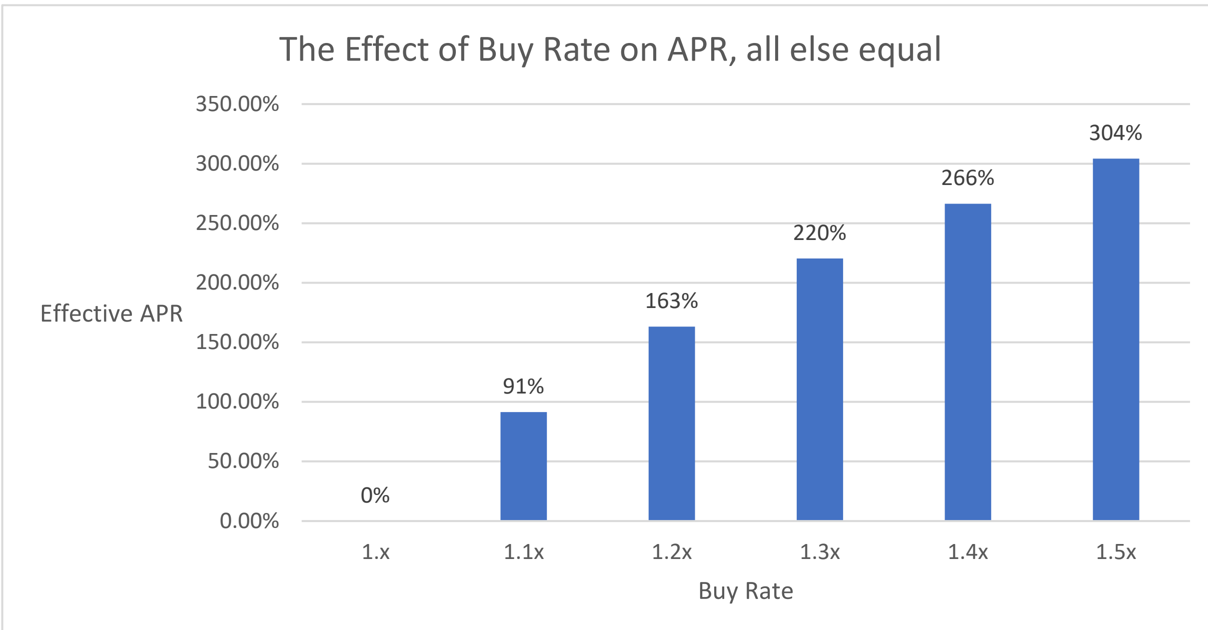
In this example, Bill's buy rate of 1.3 means that he pays back 1.3 times what he borrowed (or 30% on top of the principal). This means that Bill owed $65,000 on his $50,000 advance. Bill paid this off in around three months, which gives an equivalent rate of 0.6% per day, or an astounding 220% annually. In the State of New York, the maximum legal interest rate is 25% per year. However, the MCA provider was able to legally charge more than eight times the legal limit because the New York does not recognize an MCA as a loan.

IX. The Math Behind the MCA

As discussed, MCA borrowers are typically subprime (risky) small businesses with little credit history. In addition, the MCA is not collateralized by any physical asset. As such, MCA providers are able to charge exorbitantly high interest rate equivalents. Analogous to a prepayment penalty in corporate debt, the sooner the MCA is repaid, the higher the interest rate equivalent. In addition, the input variable to change the number of days to fully repay the advance is the percentage of revenue remitted to the MCA. Holding all else equal, there is a direct inverse relationship between the percentage of revenue remitted and the number of days it takes to repay. Assuming a constant total sum to repay, the percentage of revenue remitted is the only figure that will determine the number of days to repay the advance. In the example with Bill's hardware store, he paid off his first MCA in three months, which gave him an APR equivalent of 220%. If Bill had paid his loan in six months instead of three, the APR equivalent would have been half, just 110%. There is an inverse relationship between the time to repay the MCA and the APR equivalent: if the borrower remits a smaller percentage of his revenues, he will pay the same total sum (borrowed amount times the buy rate), just spread over a longer period of time, thus decreasing APR. In order for Bill to have an APR equivalent of his state's legal maximum of 25%, he would have to spread his payments over more than two years. The following graph shows how differing number of days to fully repay the MCA affect the equivalent APR that Bill pays.



Another major input to determine the APR equivalent is the buy rate. As discussed, the buy rate determines the total amount of money the borrower will pay to the MCA provider. Therefore, the higher the buy rate the higher the APR, all else equal. The following uses the numbers from the hypothetical Bill example, changing only the buy rate. As shown, the buy rate can greatly impact the APR.



Below is a sensitivity analysis for Bill's MCA. It shows his APR equivalent for different combinations of buy rate and the number of days it takes him to fully repay the advance. Intuitively, the higher the buy rate means the higher the APR equivalent, all else equal. Less intuitively, the APR equivalent decreases as the time to fully repay the advance increases. In terms of APR, an MCA borrower is essentially penalized for repaying the advance sooner. In a sense, the borrower is disincentivized to repay the advance in a timely manner, because to do so means to pay a higher interest rate.

	Buy Rate									
	1.1x	**1.2x**	**1.3x**	**1.4x**	**1.5x**	**1.6x**	**1.7x**	**1.8x**	**1.9x**	**2.0x**
30	229%	445%	651%	848%	1038%	1222%	1399%	1572%	1740%	1904%
60	116%	226%	330%	430%	525%	618%	707%	794%	878%	961%
90	78%	151%	221%	288%	352%	413%	473%	531%	587%	642%
120	58%	114%	166%	216%	264%	311%	355%	399%	441%	483%
150	47%	91%	133%	173%	212%	249%	285%	319%	353%	386%
180	39%	76%	111%	144%	177%	207%	237%	266%	295%	322%
210	34%	65%	95%	124%	151%	178%	204%	228%	253%	276%
240	29%	57%	83%	108%	133%	156%	178%	200%	221%	242%
270	26%	51%	74%	96%	118%	139%	158%	178%	197%	215%
300	23%	46%	67%	87%	106%	125%	143%	160%	177%	194%
330	21%	42%	61%	79%	96%	113%	130%	146%	161%	176%
360	20%	38%	56%	72%	88%	104%	119%	133%	148%	161%

Number of Days to Fully Repay

The following shows a sensitivity analysis of the APR equivalent for different combinations of the percentage of sales remitted for the MCA and the buy rate. Like the last table, this shows that the higher the buy rate the higher the APR, all else equal. This table also shows that the higher the percentage of revenues remitted for the MCA, the higher the APR. This should make sense because holding revenue constant, the higher the percentage of revenue allocated to repaying the MCA means the sooner it will be fully paid off. And as the data table shows, the sooner the MCA is paid off, the higher the APR (and vice versa).

Percent of Revenue Remitted	Buy Rate 1.1	1.2	1.3	1.4	1.5	1.6	1.7	1.8	1.9	2
5%	46%	82%	111%	134%	153%	168%	181%	192%	201%	209%
10%	91%	163%	220%	266%	304%	335%	361%	383%	402%	417%
15%	136%	243%	329%	398%	455%	501%	540%	573%	601%	625%
20%	181%	323%	437%	529%	604%	667%	719%	762%	800%	831%
25%	225%	402%	543%	658%	753%	831%	896%	951%	997%	1037%
30%	268%	479%	649%	787%	900%	994%	1072%	1138%	1194%	1242%
35%	311%	557%	754%	914%	1046%	1156%	1247%	1325%	1390%	1446%
40%	353%	633%	858%	1041%	1192%	1317%	1422%	1510%	1585%	1649%
45%	395%	708%	961%	1167%	1336%	1477%	1595%	1695%	1779%	1852%
50%	436%	783%	1063%	1291%	1480%	1636%	1768%	1879%	1973%	2053%
55%	477%	857%	1164%	1415%	1622%	1794%	1939%	2061%	2165%	2254%
60%	517%	930%	1264%	1538%	1764%	1952%	2110%	2243%	2357%	2455%
65%	557%	1003%	1364%	1660%	1904%	2108%	2279%	2425%	2548%	2654%
70%	597%	1075%	1462%	1780%	2044%	2263%	2448%	2605%	2738%	2852%
75%	636%	1146%	1560%	1900%	2182%	2418%	2616%	2784%	2927%	3050%
80%	674%	1216%	1657%	2019%	2320%	2571%	2783%	2963%	3116%	3247%
85%	713%	1286%	1753%	2138%	2457%	2724%	2949%	3140%	3304%	3444%
90%	750%	1355%	1848%	2255%	2593%	2876%	3114%	3317%	3490%	3639%
95%	788%	1424%	1943%	2371%	2728%	3026%	3279%	3493%	3676%	3834%
100%	825%	1491%	2037%	2487%	2862%	3176%	3442%	3668%	3862%	4028%

Although the buy rate and the percentage of revenue remitted (time to repay) influence the APR, only the latter has an impact on the profit margin. Remember that MCA repayment is a flat percentage of monthly revenue, not a constant dollar amount. This means that a one percent increase in the monthly revenue remitted represents a one percent decrease in profit margin. The following data table shows the changes in profit margins from changes in buy rate and percent of revenue remitted. Only the percentage of revenue remitted affects the profit margin; the buy rate does not. Increasing the buy rate for a constant percentage of revenue remitted will not decrease the monthly profit margin, it will only increase the number of months where the percentage of revenue is being remitted to repay the advance.

Percent of Revenue Remitted \ Buy Rate	1.1	1.2	1.3	1.4	1.5	1.6	1.7	1.8	1.9	2
5%	20%	20%	20%	20%	20%	20%	20%	20%	20%	20%
10%	15%	15%	15%	15%	15%	15%	15%	15%	15%	15%
15%	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%
20%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%
25%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
30%	-5%	-5%	-5%	-5%	-5%	-5%	-5%	-5%	-5%	-5%
35%	-10%	-10%	-10%	-10%	-10%	-10%	-10%	-10%	-10%	-10%
40%	-15%	-15%	-15%	-15%	-15%	-15%	-15%	-15%	-15%	-15%
45%	-20%	-20%	-20%	-20%	-20%	-20%	-20%	-20%	-20%	-20%
50%	-25%	-25%	-25%	-25%	-25%	-25%	-25%	-25%	-25%	-25%
55%	-30%	-30%	-30%	-30%	-30%	-30%	-30%	-30%	-30%	-30%
60%	-35%	-35%	-35%	-35%	-35%	-35%	-35%	-35%	-35%	-35%
65%	-40%	-40%	-40%	-40%	-40%	-40%	-40%	-40%	-40%	-40%
70%	-45%	-45%	-45%	-45%	-45%	-45%	-45%	-45%	-45%	-45%
75%	-50%	-50%	-50%	-50%	-50%	-50%	-50%	-50%	-50%	-50%
80%	-55%	-55%	-55%	-55%	-55%	-55%	-55%	-55%	-55%	-55%
85%	-60%	-60%	-60%	-60%	-60%	-60%	-60%	-60%	-60%	-60%
90%	-65%	-65%	-65%	-65%	-65%	-65%	-65%	-65%	-65%	-65%
95%	-70%	-70%	-70%	-70%	-70%	-70%	-70%	-70%	-70%	-70%
100%	-75%	-75%	-75%	-75%	-75%	-75%	-75%	-75%	-75%	-75%

All of these data tables make the following assumptions as the baseline, taken from the illustrative example of Bill's hardware store.

Assumptions	
Advance Amount	50000.0
Buy Rate	1.30
Payback Amount	65000.0
% of Rev. Remitted	10.0%
Est. Monthly Revenue	216000.0
Repayment time (days)	90.3
Daily Payment	720
Daily Interest Rate	0.60%
APR	**220.30%**

X. A Look into Yellowstone Capital and Lawsuit

The 2000 film *Boiler Room* depicts aggressive stockbrokers trying to get rich using shady tactics on unsuspecting clients. The lead character in the movie, Seth Davis, was based on real-life convicted insider trader David Glass. After getting fired from his day trading job for breaking securities laws and while still on probation, Glass started his own merchant cash advance lender and brokerage called Yellowstone Capital. Yellowstone hired aggressive brokers to originate MCAs to small businesses, but soon found that some of the borrowers were unable to pay back the money. Glass found that lawsuits were too costly and time consuming, so beginning in 2012 his firm began making borrowers sign a *confession of judgment* as part of the terms of the MCA. This document would allow the MCA provider to seize the borrower's assets if they are accused of missing even a single payment. Although not enforceable in many states, a small number of courts in counties in upstate New York overwhelmingly rule in favor of the MCA providers that have the confession of judgment, regardless of the jurisdiction of the small business. In fact, during a 30-day period one clerk in Orange County, New York issued 176 judgments against small businesses across 38 states and Puerto Rico. Since 2012, MCA providers have used this technique more than 25,000 times, totaling $1.5 billion. By 2017, Yellowstone had originated over $550 million in MCAs and filed around 25% of all confessions of judgments for this industry. Many borrowers have also accused Yellowstone of forging a signed confession of judgment, claiming they never signed one.[15]

[15] https://www.bloomberg.com/graphics/2018-confessions-of-judgment/

XI. How MCAs are Funded

Any bank, from a small-town single-location community lender to a major Wall Street firm all face the same usury laws in a given state. As discussed, merchant cash advance providers are not subject to these laws. Not wanting to miss out on subprime lenders willing to pay hundreds of percentage points in APR, major banks have found ways to profit from MCAs.

One MCA provider known as OnDeck averages 54% effective APR on its advances that it is able to originate through an MCA brokerage it partnered with. Brokers are known to cold call and fax small business indiscriminately. OnDeck will approve a borrower for a particular rate using its algorithm and data and allow the sales broker to charge whatever rate they desire (up to 12% above the approved rate), allowing them to collect the difference. It is common for the brokers to include additional fees, although in theory OnDeck forbids this. Despite this, one small business owner in Glendale, Arizona borrowed $30,000 from OnDeck and had to pay a "$2,520 guarantee fee, a $750 origination fee, a $500 OnDeck platform fee, and a $387 servicing fee." Including fees, this advance the advance had an APR equivalent of 110%, which was stacked on top of a previous advance from Yellowstone Capital. Within a month and a half, the business filed for bankruptcy. This is an all-too-common story for many MCA borrowers from firms like OnDeck. The brokers with whom OnDeck has partnered have questionable ethics, including "brokers convicted of stock scams, insider trading, embezzlement, gambling, and dealing ecstasy… past and present employees includes a former hedge fund manager convicted of stock fraud and a recovering heroin addict on probation for a motel stickup gone bad. One new hire stopped coming to work after he robbed a bank."

OnDeck Capital is publicly traded on the New York Stock Exchange (ONDK). Before that, OnDeck raised $180 million in capital from Google Ventures, Peter Thiel, and others, plus over $300 million from Goldman Sachs and other banks to provide cash for the MCAs. Morgan Stanley, JP Morgan, and Deutsche Bank underwrote the IPO in 2014 that valued OnDeck at around $1.5 billion.[16] These banks are required to perform extensive due diligence on their borrowers and can only charge up to the legal non-usurious interest rate. However, by investing in MCA providers they are able to profit from a business model in which they are not allowed to directly operate. These banks have also begun "package the loans into securities that can be sold to investors," similar to how the banks securitized subprime mortgages preceding the 2008 financial crisis. OnDeck is a loan shark masquerading as a tech company and is able to attract hundreds of millions of dollars from prominent venture capital firms and public market investments. OnDeck competitor CAN Capital has raised equity from Accel Partners (early investor in Facebook), and more than $650 million in debt from banks like Wells Fargo, Barclays, JP Morgan, Morgan Stanley, SunTrust, and UBS.[17]

XII. Analysis of Usury Laws

In the United States, there is no federal law dictating the maximum rate of interest permitted. Instead, this is decided at the state level. Most states have what are known as usury laws to cap the interest rates of transactions. For example, Utah had a usury law that stated the maximum legal interest rate of 10%. However, this law was repealed in the 1980s, and now any interest rate is legal in the state of Utah, so long as there is a valid contract. Since the law was repealed, Utah has seen an increase in predatory lending, and leads the nation in loansharking.[18]

[16] "OnDeck IPO: Shady Brokers Add Risk in High-Interest Loans - Bloomberg."
[17] "Wall Street Finds New Subprime With 125% Business Loans - Bloomberg."
[18] "Why Does Utah, of All Places, Lead Nation in Loan Sharking? | Columns | Hjnews.Com."

Public opinion and perhaps a court of law would find a loan with an APR of 500% to be usurious and unconscionable. However, it is not a simple solution. It is debated if usury laws are necessary or if they are misguided. Critics of usury laws argue that people need access to credit. And many individuals and small businesses are not what a lender would consider creditworthy. This means they have a poor history of repaying loans and likely little chance of being able to repay. The riskier an investment, the higher the required return – lenders have a hurdle of the risk-adjusted return that they require in order to lend out money. If there is a high chance of them losing their investment, they require a high price in return. With usury laws, the non-creditworthy borrowers (who happen to be those who typically need fast money the most) would be unable to obtain any sort of credit – they are too risky for a lender to agree to give them a loan at the legal interest rate limit.

The Online Lenders Alliance argues that "restricting access to legal and licensed credit does nothing to address the underlying need for small-dollar loan products and could force millions of people to seek out dangerous alternatives such as unscrupulous, unlicensed, offshore or otherwise illegal lenders." In other words, if there are usury laws, millions of people would be unable to obtain legal credit and will have to obtain this money from less-than-ideal sources. This fuels MCA lending and organized crime, like mafia loansharking commonly depicted in Hollywood. Proponents of usury laws argue that people in need of help can turn to credit unions, charities, and religious organizations rather than payday loans. This may be true, but it leaves small businesses with nowhere to turn.[19]

The World Bank provides support against usury laws. Their research found that these laws “reduce credit extension” in that “too low ceilings on lending rates can lead to a reallocation

[19] “A Ban On High-Cost Loans May Be Coming.”

from small borrowers to large commercial borrowers or the government, which are less risky and cheaper to administer." In other words, the small borrowers will be harmed more than the large ones. It explains further: "interest rate caps can force lenders to stop expanding or even withdraw services to remote rural areas and focus instead on urban areas that are less expensive to service (Miller, 2013). Cut off from the formal financial system, small borrowers may be forced to turn to informal lenders, which are not regulated and charge substantially higher rates."[20] This is the niche where MCAs focus.

XIII. Silicon Valley MCAs

Similar to how VC funds and big banks have been entering the MCA space, a number of technology giants have started providing their own versions of merchant cash advances. While they do not call it a "merchant cash advance" Amazon offers "working capital loans" for the third-party vendors on its platform. These are loans designed specifically for small and medium sized businesses that sell on Amazon's website. Funds are received within five days of applying and is financed through Marcus by Goldman Sachs. Amazon Lending's process works in a similar fashion to a traditional merchant cash advance. From Amazon's website: "Loan payments are automatically deducted from the first seller account disbursement following your loan payment due date. If the first disbursement following your due date is insufficient to make the full loan payment, we will deduct the remaining balance from the next disbursement." Note the similarities between this and an MCA. Amazon lending does not check credit score and is invitation-only. It relies on the data it collects from its sellers to determine if they are creditworthy. These loans are available to the six million sellers on the platform and range from

[20] Ferrari, Masetti, and Ren, *Interest Rate Caps*.

$1,000 to $750,000. Like an MCA, the borrower repays a lump sum with an implied interest rate. Unlike MCAs that can have APR equivalents of well over 100%, Amazon loan rates range from around 6% to 16%

To repay the Amazon loan, borrowers pay back with fixed monthly payments that are automatically deducted from their Amazon account. This differs from a traditional MCA, where the payment is a percentage of sales, meaning if the business has a slow month they will pay proportionally less. As discussed, if the borrower of a traditional MCA pays the lump sum sooner than the agreed upon time period, they are paying a higher APR equivalent. This is because the sum to be paid back is the same, just over less time. Amazon takes this into account – "You may pay off your loan balance at any time without a prepayment penalty. Early payment would also result in interest savings, as we prorate interest due based on the remaining balance."[21] Below is a table that shows a hypothetical Amazon vendor that has a loan from Amazon. Note the constant monthly payment of $2,000 – regardless of the revenue each month.

Amazon Lending	**Constant Revenue**			**Decreased Revenue**			**Increased Revenue**		
Month	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**
Revenue	20000	20000	20000	10000	10000	10000	30000	30000	30000
Net Profit (before loan payment)	4000	4000	4000	2000	2000	2000	6000	6000	6000
Amazon Loan Payment	-2000	-2000	-2000	-2000	-2000	-2000	-2000	-2000	-2000
Profit	2000	2000	2000	0	0	0	4000	4000	4000

[21] "Amazon Lending."

This contrasts with an MCA, that requires a fixed *percentage* of sales. The table below shows the same hypothetical business but has an MCA instead of an Amazon loan. Notice how the MCA payments will decrease when the revenue decreases and will increase when revenue increases. In this example, the payments are 10% of monthly revenue. In this example, profits are higher for the Amazon loan scenario than the MCA when revenue increases by the same amount, because the Amazon loan is a fixed amount, whereas the MCA is a fixed percentage of sales. Conversely, profits for the Amazon loan become negative when revenue falls while remaining positive for the MCA. However, it is important to remember that the Amazon loan usually charges a maximum of 16% APR, compared to potentially hundreds of percentage points for the MCA.

MCA Lending	**Constant Revenue**			**Decreased Revenue**			**Increased Revenue**		
Month	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**
Revenue	20000	20000	20000	10000	10000	10000	30000	30000	30000
Net Profit (before loan payment)	4000	4000	4000	2000	2000	2000	6000	6000	6000
MCA Payment	-2000	-2000	-2000	-1000	-1000	-1000	-3000	-3000	-3000
Profit	2000	2000	2000	1000	1000	1000	3000	3000	3000

Another technology company, Square, used to originate merchant cash advances. However, they have since shifted to what they call "flexible business loans" through its program Square Capital and Square Installments. Square Capital provides business loans between $300 to $100,000 to qualified customers. Square is a digital payments processor, so it has ample data on the businesses it lends to, which helps the firm decide the terms of the loan based on the perceived riskiness. Similar to Amazon, Square's incentives are aligned with its borrowers. Their core business is to process digital payments for their customers. Square provides these businesses with loans so that their clients can expand their operations and become more successful, meaning Square can earn more money by processing more payments. Like Amazon lending, Square Capital and Square Installments support a separate core business – unlike an MCA provider, the goal is not to maximize profit from lending money.

Traditional MCAs thrive regardless of how their clients perform. Brokers get their commissions when the advance is originated, and MCA providers can stack advance on advance, each time collecting fees. On the other hand, Amazon and Square thrive when their clients are successful and grow. For example, Amazon loans provides funds only for the sellers on its platform. Its intention is to support its more important business of having vendors on its platform. Amazon profits the most when the vendors on its platform are successful, and they lend them money so that they can expand and become even more profitable. It is harmful to Amazon's primary business model to overcharge its vendors on loans in order to make a quick commission and usurious loan. Rather, it is in Amazon's best interest for their sellers to have fast and fair financing. Unlike for MCAs, the moral hazard does not exist.

The more friendly financing these small businesses can get, the more business they will bring to Amazon, and the more profit Amazon will make. MCAs are trying to make a quick buck off the loans, whereas Amazon is playing the long game, one that is more profitable. Amazon doesn't charge anywhere near the interest rate that MCAs charge because they are not maximizing profits for the loans – they are maximizing the sales on the platform in the long run.

Unlike with traditional MCA lenders, Amazon's and Square's goals are aligned with their borrowers. MCAs are more like loan sharks -- their business model is about making money from the money they lend. That being said, the purpose of the MCA is to provide credit for the non-creditworthy, the so-called "unbanked." Recall that Amazon lending and Square Capital only provide loans to *qualified* borrowers who are also clients of their core businesses. This means that many of the small businesses that take MCAs are not eligible. Furthermore, MCAs can be spent on anything a business needs, whereas Amazon Lending can be only be used on inventory for the Amazon platform. In an MCA, if the business goes under, the firm cannot collect since there is no more revenue. For Amazon Lending, the inventory of the small business acts as collateral – if they can no longer pay the loan, Amazon can legally seize the borrower's inventory.

XIV. The Industry Moving Forward

In the summer of 2019, New York State passed a law that prohibits confessions of judgment against debtors in other states to be filed in New York courts.[22] This is a big step, since the vast majority of judgments were against non-New York businesses. Furthermore, the Federal Trade Commission sued Yellowstone in the summer of 2020, alleging that the firm "used deception to lure small business customers, then regularly withdrew money from their accounts without consent even after the customers had repaid the money they owed."[23] Finally, in December 2020, the state of New Jersey sued Yellowstone, with the accusation of "deceiving small businesses and offering loans on predatory terms."[24] These represent some of the first steps in regulating the merchant cash advance industry.

The MCA industry is a relatively obscure field within finance. Those aware of the industry likely know about its bad reputation, typically associating it with its shady and usurious

[22] Murray, "It's Official, The Confession of Judgment Era Is Over."
[23] "FTC Alleges Merchant Cash Advance Provider Overcharged Small Businesses Millions | Federal Trade Commission."
[24] "N.J. Says Cash-Advance Pioneeer Deceived Borrowers - Bloomberg."

practices. However, MCAs serve a purpose. It is wrong to say that they should be banned outright or should be illegal. If a business needs quick capital to cover liquidity needs and no bank approves their application, it often has no option other than an MCA. This industry exists because small businesses that cannot borrow through traditional finance need to borrow money, despite the unfavorable terms. If a business must choose between shutting down or taking an MCA to have a chance of surviving, it makes sense to take an MCA, even if it is predatory. Banning the MCA industry entirely, although likely well-intentioned, would have the unintended consequence of leaving thousands of small businesses across the country without any access to financing: they would lose their lender of last resort.

That being said, even a modicum of regulation should be able to improve the industry. Whether through self-regulation or government legislation, MCAs have the chance to clean up their act. Eliminating the possibility of stacking MCAs would eliminate the debt spiral trap and requiring more disclosure and licensing for brokers would ensure that businesses know exactly what they are getting with their MCA. Some argue that setting an APR limit an MCAs could improve the industry. This could be an appropriate solution. However, MCA providers may end up increasing the buy rate and extending the time to repay the advance, which would increase the total amount a borrower must repay but would artificially deflate the APR. Additionally, MCA providers may cease lending to riskier borrowers since they would not allowed to be compensated for the level of risk they are taking.

Furthermore, MCAs have a niche in the economy largely because of government failures. Usury laws prevent banks from charging their risk-adjusted required rate of return from small business loans, so they opt to not lend to these businesses. Banking regulations have made it difficult for small banks to compete with big banks, while simultaneously disincentivizing small business lending with onerous requirements. The inefficient and underfunded Small Business Administration is unable to provide adequate loans to small businesses in need. If banks are able to charge higher interest rates or are somehow incentivized to lend to small businesses, this would reduce the market for MCAs. Additionally, new disruptive technology like peer-to-peer and decentralized blockchain lending pose a potential alternative to MCAs.

XV. Conclusion

One of the tenets of a great economy is access to capital. Currently, small businesses largely lack financing. This issue poses an existential threat for thousands of small businesses, which are already facing increasing competition from multinational retailors. In addition to economies of scale, big businesses have access to capital since they are more able to obtain traditional lending from banks and do not have to rely on MCAs. The world is seeing the shift from small, independently run local business to large multinational conglomerates. The lack of financing for these small businesses only exacerbates this issue.

Overall, the merchant cash advance industry is largely unstudied, undiscussed, and underreported. The general credit market is highly scrutinized by state and federal legislators and watchdogs, yet MCAs operate with essentially no restrictions. The merchant cash advance industry is a multi-billion-dollar industry but receives almost no regulation or mainstream media attention. This is changing. Like for most things in the financial world, it seems that regulation is coming, albeit slowly. As discussed, states are beginning to see the predatory aspect of MCAs and are taking action. In doing so, it is important for regulators to clean up the industry, but not to use too blunt an instrument. Yes, this industry should have some regulations to avoid fraud and predatory practices. For example, there should be required training and licensing for MCA brokers and more transparency in the MCA terms and conditions. However, it is important to remember that this is an industry that serves the unbanked and non-creditworthy. Despite paying an interest rate far higher than legally allowed, most MCA borrowers have no other financing option. Banning the industry outright would ensure that no small business is taken advantage of by an MCA provider, but many of these businesses would lose their only source of financing. Regulators must legislate on the fine line between protecting borrowers, while at the same time ensuring that these borrowers do not lose their lenders of last resort. Simultaneously, the market is seeing technology companies coming up with their own versions of an MCA. These solutions are less predatory, since they charge more reasonable interest rates, and because the lenders and the borrowers have aligned objectives. These innovations eliminate the moral hazards that exist with a traditional MCA.

In the coming years, the merchant cash advance industry will likely face existential challenges. Between legislation and competing innovation, it is unclear how the industry will operate or if the industry will survive.

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