

Mitigating Risk in the Merchant Cash Advance Industry

June 13, 2019

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Mr. Samlin's practice focuses on representing financial institutions, corporations and other entities in mortgage banking and consumer financial services issues. He regularly counsels clients on compliance with state and federal laws affecting mortgage lending and servicing activities, including the Real Estate Settlement Procedures Act (RESPA), Truth in Lending Act (TILA), Equal Credit Opportunity Act (ECOA) and Fair Debt Collection Practices Act (FDCPA). Mr. Samlin is experienced in myriad consumer lending, servicing and mortgage compliance challenges.

Prior to Pepper, Mr. Samlin was the former executive director and compliance counsel for the residential mortgage and lending businesses at Morgan Stanley, where he helped oversee the operations of Morgan's whole loan trading desk and its affiliated mortgage loan servicer, Saxon.



Gregory J. Nowak

Partner, Financial Services

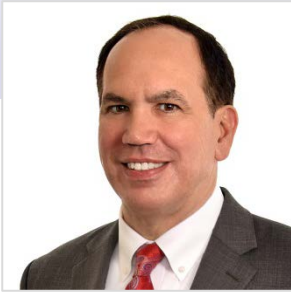
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Mr. Nowak concentrates his practice in securities law, particularly in representing investment management companies and other clients on matters arising under the Investment Company Act of 1940.

He represents many hedge funds and other alternative investment funds in fund formation and investment and compliance matters, including compliance audits and preparation work.

Mr. Nowak writes and speaks frequently on issues involving investment management, health care and other matters, and is the author of five books on hedge funds.



Mark T. Dabertin

Special Counsel, Financial Services

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Mr. Dabertin has more than 25 years of broad-based experience in financial services law and regulatory compliance.

His career includes extensive experience in banking, lending, safety and soundness, and anti-money laundering. His work in regulatory compliance at large financial institutions has been marked by innovations that resulted in fundamental structural changes to existing firm-wide compliance activities, including with respect to regulatory change management, risk assessments, and vendor management.

Mr. Dabertin frequently handles the negotiation of agreements between non-bank lenders and regulated banks, and has represented both banks and non-bank parties to such relationships.



Andrew Reiser

Chairman and CEO, Kapitus

areiser@kapitus.com

Prior to co-founding Kapitus in 2006, Andy served as the CEO of Arcavista Corporation, a Managing Director of Donald & Co. Securities, Inc., EVP of Fidelco Capital Group, and President of Windsor Group, Inc. He began his career as a CPA with Coopers & Lybrand and Price Waterhouse. He holds a BS from Boston University's Questrom School of Business.





Randy Lederman

Director of Originations, Alostara Capital Finance

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Mr. Lederman is focused on raising the visibility of AloStar Capital Finance by building relationships with intermediary partners, private equity sponsors, fellow lenders and specialty finance companies, which in turn will increase opportunities for clients in the region.

Lederman brings experience in business development, leveraged finance and bankruptcy/restructuring to AloStar. Most recently, he served as director in Cowen's Special Situations Group in New York City. At Cowen, Lederman was responsible for sourcing and executing distressed investment banking transactions for both debtors and creditors.

Prior to Cowen, Lederman spent time at various middle market investment banks, and began his career as an analyst in Bank of America's Liability Management Group.





Jesse Carlson

Senior Vice President and General Counsel, Kapitus

mcarlson@kapitus.com

Jesse is the Senior Vice President and General Counsel of Kapitus. Prior to joining Kapitus in June of 2017, he served as Counsel in the Professional Liability & Financial Crimes Section of the FDIC's Legal Division and practiced at Williams & Connolly LLP, where he focused on complex financial services, litigation and professional liability litigation. He also served as the Judicial Law Clerk to the Honorable John M. Rogers of the U.S. Court of Appeals for the Sixth Circuit. He received his law degree from the Georgetown University Law Center and his undergraduate degree from Colby College.



Audio

The screenshot displays the Cisco Webex Events interface. At the top, the title bar reads "Cisco Webex Events" with standard window controls. Below the title bar is a menu with "File", "Edit", "View", "Communicate", "Participant", "Event", and "Help". The main content area shows a video player with a title "Viewing Pepper Hamilto..." and a large red text overlay: "Audio should stream automatically on entry through your computer speakers". Below this, a banner reads "Pepper Hamilton Webinar". At the bottom of the video player, there is a logo for "Pepper Hamilton LLP Attorneys at Law".

On the right side, a "Participants" panel is visible, showing a list of participants under "Panelist 1" and "Attendee". The host is "Brian Dolan (Host)" and the attendee is "Brian Dolan (me)".

At the bottom of the interface, there is a control bar with icons for mute, video, chat, and other functions. A "Audio Broadcast" dialog box is open, showing "24.7 Kbps" and buttons for "Pause" and "Stop".

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File Edit View Communicate Participant Event Help

Cisco Webex Events

Connected

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Audio Broadcast
24.7 Kbps
Pause Stop

Participants

Panelist 1

Brian Dol... (Host)

Attendee:

Brian Dolan (me)

Q&A

Q&A

Cisco Webex Events

File Edit View Communicate Participant Event Help

BD
Brian Dolan (Host)

Viewing Pepper Hamilto... ▾

Click here to send questions to us

Pepper Hamilton Webinar

Audio Broadcast
24.7 Kbps
Pause Stop

Pepper Hamilton LLP
Attorneys at Law

Participants

- Panelist: 1
 - BD Brian Dol... (Host)
- Attendee:
 - BD Brian Dolan (me)

Q&A

The webinar portion of the program will be starting at approx. 5:30pm ET. There is currently no audio until we start.

We are on mute and will be starting in a few minutes.

Email dolanb@pepperlaw.com if interested in receiving a CLE form.

Financing MCA Operations

- Balance Sheet Financing
- Participations
- Securities, Tax and Business Considerations

MCA – on balance sheet financing

1. Why is this important?
2. What is it you are issuing?
3. Who is the issuer?
4. When is the best time?
5. How is this done? Is an exemption available?

Why is this important?

- ▶ Like the clients of the MCA firm, the MCA firm needs capital, to invest in MCATs
- ▶ Deciding to bring in “partners” is a momentous step – dealing with OPM and the risks that entails
- ▶ Do you have the infrastructure –
 - A CFO who can muster the resources internally (or find them externally) to produce reports worthy of the firm and investor attention
 - Who will be assigned investor relations duties?
 - Who will vet materials for accuracy, completeness and timeliness?

What is the MCA firm issuing?

- ▶ Don't delude yourself, it is a security
- ▶ Debt?
 - convertible notes
 - warrant coverage
 - impact of hard money borrowing and your margins
 - have you run the sensitivity analysis
- ▶ Equity?
 - common
 - preferred
 - hybrid
 - ico?
- ▶ Use a finance subsidiary? Offshore?

Who is the issuer?

- ▶ This is harder than you might think...
 - Ultimately who bears the risk
 - Who gets sued in bankruptcy?
 - Are investors/note holders secured? By what??

- ▶ If you use an SPV or offshore entity, beware the tax man!!
And FinCen.

When is the best time?

- ▶ Is the MCAT firm ready to issue debt or equity on its balance sheet?
- ▶ Track record?
- ▶ Audited financial statements available?
- ▶ Are any of the principals “bad actors” as defined in Reg D Rule 506(d)?

How is this done?

- ▶ By subscription – need a subscription agreement and a disclosure document (PPM) -- this is also known as you estoppel document and must list all material risk factors that are known or knowable.
- ▶ Need to fit within an exemption under the Securities Act of 1933
 - Are you an underwriter or acting as one?
 - Reg D is most common
 - JOBS Act gave us “a general solicitation in the context of a private placement” under Rule 506(c) of Reg D
- ▶ DO NOT IGNORE NEW YORK STATE – Filing Form 99 is the cheapest insurance you will ever buy...

How is this done? (continued)

▶ Regulation D

- 506(b) friends and family –
 - NO solicitation,
 - NO open website,
 - NO advertising of any sort
 - can accept a limited number of unaccredited investors
 - self certification of status
- 506(c) general solicitation in the context of a private placement
 - Advertising (open web, banner plans, Times Square Billboards) allowed
 - Must verify accredit investor status and maintain records

▶ Regulation A+ (Also a JOBS Act add -on)

▶ Full blown '33 Act Registration

MCA – off balance sheet financing

- ▶ Use of Syndications
- ▶ Use of Partnerships
- ▶ Use of Participations

What Is A Security?

- ▶ Howey test
 - investment of money
 - in a common enterprise
 - with the expectation of profit
 - from the efforts of others

What Is A Syndication?

- ▶ Debts issued by a consortium of lenders to a sole borrower.
- ▶ There is a “lead lender” or arranger for each consortium.
 - Lead is responsible for facilitation of the loan and allocating cash flows to the other consortium members.
 1. Underwritten deal
 2. Club deal
 3. Best-Efforts Syndication Deal

Partnership?

- ▶ '40 Act issues and Advisers Act Issues??
- ▶ Tax Issues
- ▶ Does holder have debt or equity?
- ▶ Who has custody of the assets? Do they have legal competence?

What Is A Participation?

“Participations are not loans; they are contractual arrangements between a lender and a third party, in which the third party, or participant, provides funds to the lender. The lender in turn uses the funds from the participant to make loans to the borrower.” If the agreements are “true participations,” [citations omitted] and thus sales rather than loans, then the funds are effectively removed from the res. of the estate.”

Rothenberg v. Oak Rock Fin., LLC, 14-cv-3700, USDC, EDNY (March 31, 2015).

Elements of A Participation

1. Money is advanced by participant to a lead lender;
2. A participant's right to repayment only arises when a lead lender is paid;
3. Only the lead lender can seek legal recourse against the borrower; and
4. The document is evidence of the parties' true intentions.

Rothenberg.

Factors That Signify A Debtor Creditor Relationship

1. Guarantee of repayment by the lead lender to a participant;
2. Participation that lasts for a shorter or longer term than the underlying obligation;
3. Different payment arrangements between borrower and lead lender and lead lender and participant; and
4. Discrepancy between the interest rate due on the underlying note and interest rate specified in the participation.

Participation or Loan?

“The most determinative factor of all of these is the risk allocation involved in the transaction. If the participant does not bear the same risk of loss as the seller, or if the seller has made a guarantee of payment to the participant, the transaction [*28] is generally considered a loan and not a sale.” *In re Corporate Financing, Inc.*, 221 BR. 671 (Bankr. E.D.N. Y. 1998). “In a typical participation agreement, the lead lender makes no warranties or guarantees about the borrower's ability to repay the underlying loan. Thus, an indicium of a loan is the guarantee of repayment by the lead lender to a participant.” *In re Sackman Mortgage Com.*, 158 B.R. at 933.

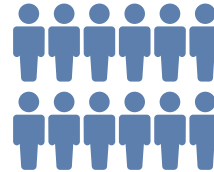
Financing an MCA Company...From Cradle to Grave

Kapitus Overview

Kapitus provides financing to small businesses in the US



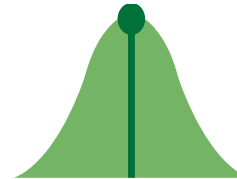
2006
Established as
Strategic Funding Source



237
Employees



\$2B+
In Capital
Provided



Institutionally
Backed



40K+
Small Businesses
Served



World Class
Board



New York
120 W 45th Street
New York, NY 10036



Virginia
2500 Wilson Blvd.,
Suite 350
Arlington, VA 22201



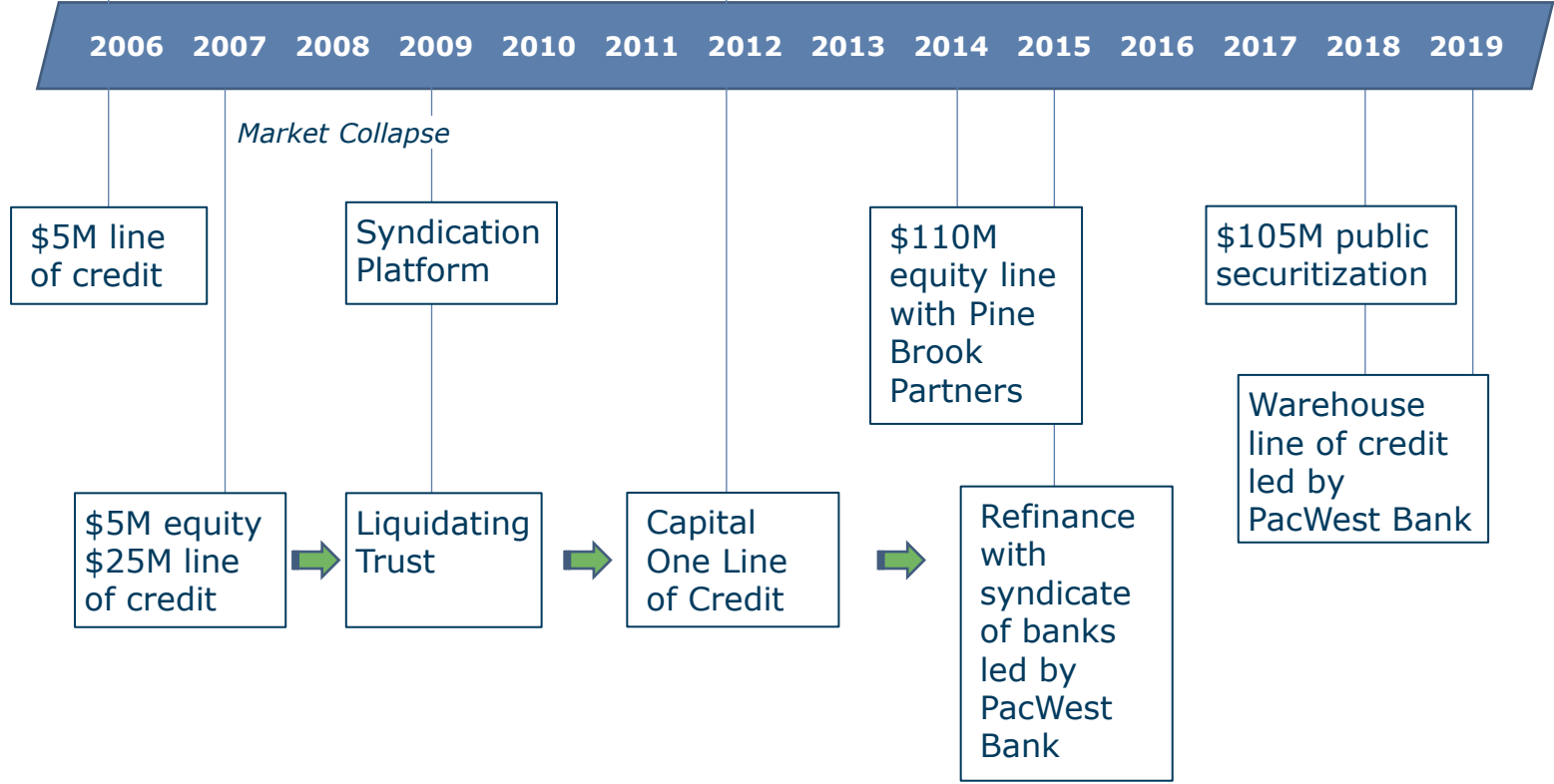
Texas
2500 Discovery Blvd.,
Suite 200
Rockwall, TX 75032

Our Financing Journey

Friends and Family



Institutional Financing



Financing Details

<p>\$1.02M Debt</p> <ul style="list-style-type: none"> • 3-year convertible • 2/3 converted in 12-18 months • Remainder paid at end of term <p>2006</p>	<p>\$5M Line of Credit</p> <ul style="list-style-type: none"> • High cost (17.25%) • Virtually 100% leverage • Minimal covenants • No personal guarantees <p>2006</p>	<p>\$2M Equity</p> <ul style="list-style-type: none"> • 3 High net worth friends • Minority ownership with preemptive rights <p>2006</p>	<p>\$5M Equity; \$25M LOC</p> <ul style="list-style-type: none"> • Large hedge-fund • Preemptive rights • Covenants on debt • Board seat <p>2007</p>
<p>Liquidating Trust</p> <ul style="list-style-type: none"> • Hedge-fund collapses • Debt sold to a Liquidating Trust upon market collapse • Negotiated extended terms at a default interest rate <p>2009</p>	<p>Syndication Platform</p> <ul style="list-style-type: none"> • Industry first • Allowed brokers to invest in deals <p>2009</p>	<p>\$5M Equity</p> <ul style="list-style-type: none"> • Raised equity from a family office <p>2012</p>	<p>Capital One LOC</p> <ul style="list-style-type: none"> • Refinanced Liquidating Trust's debt • Extensive restrictions and covenants <p>2012</p>
<p>\$110M Equity Line</p> <ul style="list-style-type: none"> • Pine Brook Partners • \$35M initial draw (\$25M in company, \$10M secondary shares) • Additional \$25M as needed for growth <p>2014</p>	<p>\$135M Line</p> <ul style="list-style-type: none"> • Syndicate of four banks led by PacWest <p>2015</p>	<p>\$105M Securitization</p> <ul style="list-style-type: none"> • Public securitization managed by Guggenheim • Allows increases up to \$500M • SPV structure • Multiple limitations <p>2018</p>	<p>\$85M Warehouse</p> <ul style="list-style-type: none"> • Led by PacWest Bank • 95% advance rate • Expanded capabilities and facility size <p>2018 / 2019</p>

Add to the Financing Stack: Forward Flow Wholesale Loans

MCA Cases and Legislation

What Is Merchant Cash Advance?

Merchant Cash Advance is a specialized form of accounts receivables factoring—

- “Factoring is a financial transaction and a type of debtor finance in which a business sells its accounts receivable (i.e., invoices) to a third party (called a factor) at a discount. A business will sometimes factor its receivable assets to meet its present and immediate cash needs.”

Wikipedia.

- “Purchases and sales of future receivables and sales proceeds are common commercial transactions expressly contemplated by the Uniform Commercial Code.” *IBIS Capital Group, LLC v Four Paws Orlando LLC*, 2017 N.Y. Misc. LEXIS 884, 2017 NY Slip Op 30477(U), *6 (N.Y. Sup. Ct. Mar. 10, 2017).

MCA Case Law




Key factors for separating MCAs from loans under New York Case Law :

- ▶ (1) whether principal is “put in hazard” versus “in some way secured;”
- ▶ (2) existence of a reconciliation provision; and
- ▶ (3) an indefinite versus a fixed repayment term

K9 Bytes, Inc. v. Arch Capital Group

MCA Case Law

If appropriately structured, Merchant Cash Advance is not a loan–

- **Purchase and Sale Agreement** for the purchase of future receivables
- **Purchase Price: \$2 million**  **Purchased Amount: \$3 million**
(Amount is delivered as receivables come into being and are paid)
- **Specified Percentage:** e.g., 15% of all paid receipts collected each day
- **Specified Daily Amount:** To ensure even cash flow the parties estimate that 15% of paid receipts equals \$10 thousand
- **Reconciliation:** Either party can request a periodic “true-up” to ensure that 15% of paid receipts continues to equal \$10 thousand and will adjust
 or 

MCA Case Law

Key factors for sorting MCAs from loans under New York Law :

- ▶ (1) whether principal is “put in hazard” versus “in some way secured;”
- ▶ (2) existence of a reconciliation provision; and
- ▶ (3) an indefinite versus a fixed repayment term.

MCA Case Law

Courts in other states may or may not follow the New York factors:

But another important provision of the agreement is consistent with a loan and not a factoring agreement. The agreement . . . defines default broadly to include [Merchant's] violation of 'any term or covenant in this agreement.' Upon default, [Merchant] must pay to [MCA Provider] 'the full uncollected Receipts Purchased Amount plus all fees due under this Agreement . . . immediately.' This provision shifts all risk of non-collection of receivables to [Merchant] . . . [and makes] the transaction to be a financing arrangement and not a sale.

Anderson v. Koch, 2019 Minn. App. Unpub. LEXIS 205, *11-12 (Minn. Ct. App. March 18, 2019)

MCA Case Law

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Anderson v. Koch, 2019 Minn. App. Unpub. LEXIS 205, *11-12 (Minn. Ct. App. March 18, 2019)

MCA Case Law

Courts in other states may or may not follow the New York factors:

The relationship between Plaintiffs and CBSG was governed by the terms of the “Factoring Agreement”. . . However, allegedly unlike a traditional factoring agreement, the fair market value of the accounts receivable (i.e., the Receipts Purchased Amount) was unilaterally dictated by CBSG and based upon the creditworthiness of Fleetwood Services—not the creditworthiness of the customers who were to pay the accounts receivable or any appraisal of the actual value of Fleetwood Services' accounts receivables. . . .Th[e] daily payments were, like the Receipts.Purchased Amount, also divorced from Fleetwood Services's actual accounts receivable because the Factoring Agreement made “any and all receivables from any customer in any amount based on any sale subject to Defendant CBSG for payment of the daily fixed debit.”

Fleetwood Servs., LLC v. Complete Bus. Sols. Grp., 2019 U.S. Dist. LEXIS 61504 (E.D. Pa., April 10, 2019).

MCA Case Law

Courts in other states may or may not follow the New York factors:

Anderson v. Koch and *Fleetwood Servs., LLC v. Complete Bus. Sols. Grp* are similar cases in that in each instance the court's analysis centered on whether the contested MCA agreement described a bona fide factoring transaction and not on whether certain hallmarks of a loan relationship were present — this is not factoring as opposed to this is not a loan..

Other Recent Cases

Influx Capital, LLC v. Pershin, 2019 N.Y. Misc. LEXIS 1779 (N.Y. Sup. Ct. April 9, 2019).

This is a stacking case involving tortious interference claims, including the allegation that the defendant induced and funded Influx's merchant customer's allegedly frivolous lawsuits against Influx in effort to destroy Influx's reputation..

FTC Investigation of Small Business Financing

- ▶ On May 23, 2019, the FTC announced plans to investigate potential unfair and deceptive acts and practices in the small business financing industry
- ▶ The FTC interprets the term “consumer” for purposes of Section 5 of the FTC Act to include small business entities and non-for-profit organizations
- ▶ Section 5 prohibits unfair and deceptive acts or practices
- ▶ The small business itself is considered a consumer and not just the owners and employees of the business
- ▶ The FTC’s ability to pursue enforcement action against small businesses is broader than that of the CFPB, as the authority of the FTC extends beyond consumer financial products and services

<https://www.pepperlaw.com/publications/ftc-investigates-small-business-financing-based-on-expansive-view-of-udap-authority-2019-06-07/>

Government Responses to Growth of MCA Industry

Federal Level – Agency Responses

Prior to 2018

Focus on CFPB's Implementation of Section 1071

Post-November 2018

Focus on FTC Action in wake of Bloomberg Articles

State Level – Legislative Responses, Two Approaches:

Disclosure

Substantive Regulation

FTC Response to Bloomberg Articles

- ▶ May 8, 2019 held forum called “Strictly Business” that addressed small business finance broadly, with a panel focused on MCA.
- ▶ May 23, 2019 announced an investigation of small business financing practices, including, but not limited to, MCA-related acts and practices
 - The legal basis of the investigation of is the FTC’s UDAP authority under Section 5 of the FTC Act. To this end, the FTC considers small businesses to be a form of covered “consumer”
- ▶ FTC has focused on brokers, ISOs, and collection practices
 - Target of investigation is suspected to be Yellowstone
 - Funding companies may be held responsible for broker acts
 - Greater vetting of brokers may be necessary

State Legislative Action

- ▶ Disclosure
 - California: passed SB 1235
 - New Jersey: Senate passed S2226
 - New York: Senator Thomas introduced S 5470
- ▶ Bill require disclosure of various terms of MCA, key issues:
 - APR
 - California “Annualized Metric”
 - New Jersey and New York “Estimated APR”
 - Scope
 - NJ Bill exempts equipment leasing
- ▶ Talking Points with State Policymakers
 - Can’t treat like consumer credit/Businesses look at return on capital
 - Can’t import APR from TILA as a technical matter

Legislative Action

S2262

(1) the total dollar costs to be charged, including all required fees and charges that are paid and that cannot be avoided by the small business;

(2) the amount financed, which shall mean the advance amount less any prepaid finance charges; and for a cash advance the estimated annual percentage rate, provided as a range, with at least three different repayment times provided and a narrative explanation of how each rate was derived. Any estimated annual percentage rate is to be calculated using a projected sales volume that is based on the small business concern's average historical sales or the sales projections relied on by the provider in underwriting the cash advance; or

(3) for a cash advance that calculates repayment costs as a fixed payment, the annual percentage rate, expressed as a nominal yearly rate, inclusive of any fees and finance charges.

Legislative Action at the State Level

- ▶ Substantive Initiatives
 - New York – Various Proposals Pending
 - Restrictions on Confessions of Judgment
 - Application of consumer protections to small business finance
 - Application of usury cap to MCA
 - Licensing of MCAs/Brokers
 - DFS Oversight of Small Business Finance

Questions & Answers

Q&A

Cisco Webex Events

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Brian Dolan (Host)

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Global Reach

INTERNATIONAL NETWORK

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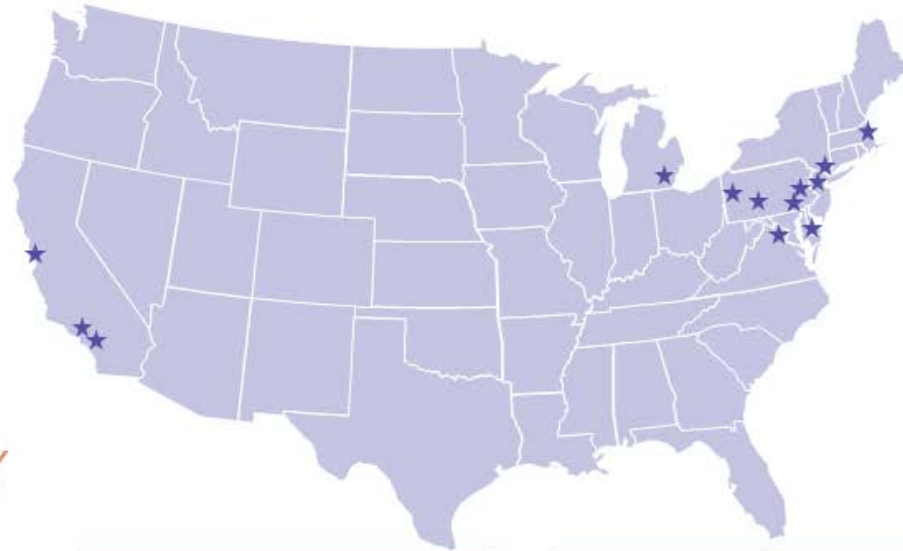
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