



Commissioner Manuel P. Alvarez
 Department of Financial Protection and Innovation
 2101 Arena Blvd., Sacramento, CA 95834

Via electronic mail - ATTN: Charles Carriere, Senior Counsel

RE: Invitation for Comments on Invitation for Comment on Proposed Rulemaking on the California Consumer Financial Protection Law (Pro 01-21). RBLC Encourages DFPI to Swiftly Protect Small Businesses with UDAAP Rulemaking.

Dear Commissioner Alvarez,

California is facing vast and permanent damage to the small business ecosystem that helps produce our middle class and the fabric of our local communities. When we drive past the closed storefronts in our towns and cities, we need no reminder that small businesses are devastated by the impacts of COVID-19,

desperate for help, and more vulnerable than ever to predation. The California State Legislature has endowed the Department of Financial Protection and Innovation (“DFPI”) with unique power to protect small businesses, and we encourage the Department to brook no delay in providing this protection.

The Responsible Business Lending Coalition (“RBLC”) is grateful for this opportunity to respond to the DFPI’s February 4th, 2021 Invitation for Comment on Proposed Rulemaking. The RBLC is a nonprofit/industry coalition of community development organizations, fintechs, consumer and small business advocates, and small business lenders that have come together in response to the growing problem of predatory small business financing. The RBLC, joined by over 45 organizations, worked with the leaders in the Legislature to support the passage of the California Consumer Financial Protection Law (“CCFPL”), including provision 90009(e) which empowers DFPI to protect small businesses.

The California legislature created the DFPI to fill gaps in financial protection regulation, especially in new and emerging industries that are unaddressed by the Consumer Financial Protection Bureau (“CFPB”). Small business financing is certainly one of the largest of these regulatory gaps. On an annual basis, an estimated 127,000 California small businesses may be overpaying for financing as a result of a lack of fair market competition, resulting in an estimated \$1.4 billion to \$12.1 billion of direct economic impact.¹ In addition, these 127,000 businesses are impacted by secondary effects of the unregulated commercial financing market, costing them tens of billions in opportunity costs, lost future revenues, and the consequences of damaged credit scores. Each of these small businesses is critical to a family’s economic well-being, and they collectively employ an estimated 1.5 million Californians. The CFPB lacks authority under the Dodd-Frank Act to protect these small businesses from unfair, deceptive, and abusive acts or practices (“UDAAP”).²

A new and growing industry of high-rate financing companies is exploiting this regulatory gap and destroying community wealth in California. The APRs charged by some emerging financing products can reach over 300%³ and a troubling record of UDAAP concerns has developed.

This lack of regulatory protection is causing disproportionate harm in communities of color. Federal Reserve research recently concluded that Black and Hispanic entrepreneurs are twice as likely to be affected by “potentially higher-cost and less-transparent credit products.”⁴ This research specifically identifies merchant cash advance (“MCA”) and factoring products as “potentially higher-cost and less-transparent credit products.”

The California State Legislature’s inclusion of § 90009(e) in the CCFPL reflects a recognition that small business owners are also individuals, and make many business financing decisions as they would on their consumer mortgage or car loan. If they fall prey to predatory lenders, they may lose their livelihoods and

¹ Responsible Business Lending Coalition, “Re: Third Invitation for Comments on Proposed Rulemaking Commercial Financing Disclosures, File No: 01-18,” January 31, 2020. See pages 2-3. http://www.borrowersbillofrights.org/uploads/1/0/0/4/100447618/rblc_comment_-_commercial_financing_disclosures_pro_01-18.pdf

² CFPB’s authority in small business financing is focused on the data collection described in Dodd-Frank Act Section 1071.

³ See, e.g. St. Louis, Weaver, Donaker Brown, and McShane, Opportunity Fund, “Unaffordable and Unsustainable: The New Business Lending on Main Street,” May 2016. <https://www.opportunityfund.org/blog/unaffordable-and-unsustainable-new-opportunity-fund-report/>; Clark, Patrick. “How Much is Too Much to Pay for a Small Business Loan,” May 16, 2014. Bloomberg. <https://www.bloomberg.com/news/articles/2014-05-16/how-much-is-too-much-to-pay-for-a-small-business-loan>

⁴ Zeeuw, Mels de, Federal Reserve Bank of Atlanta, “Small Business Credit Survey: Report on Minority-Owned Firms,” Dec 2019. <https://www.fedsmallbusiness.org/medialibrary/fedsmallbusiness/files/2019/20191211-ced-minority-owned-firms-report.pdf>

possibly their homes. Their employees may lose their livelihoods. However, consistent enforcement of new financial protections could help California small businesses create as many as 25,000 new jobs.⁵

The CCFPL's inclusion of small business protections is also a response to the economic disaster wrought by COVID-19, which has put small business in crisis and exacerbated societal inequities. A report by Yelp found that 19,000 businesses in California had already permanently closed as of September of last year.⁶

The economic pain has not been equal. Black-owned and immigrant-owned businesses have closed at more than double the rate of White-owned businesses, followed closely by Latinx-owned businesses. Asian-owned and woman-owned businesses have closed at 1.5 times the rate of white-owned businesses overall.⁷

Without CFPB protection, DFPI is the only agency that can prevent this evisceration of community wealth and economic mobility, and the disproportionate harm facing communities of color and immigrant communities.

The small business financing industry remains of critical importance to the health of California's economy. Responsible financing is offered by scores of depositories and nonbanks, nonprofit CDFIs, and fintechs in California. In fact, some of the most promising innovations in small business financing are being developed here in California. But access to these sources of responsible financing suffers when irresponsible segments of the market find unfair advantage in practices that mislead or exploit small businesses.

New and better products succeed in the market when competition rewards honest value creation. When unfair, deceptive, and abusive practices are unpoliced, competitive dynamics can penalize financing providers who are transparent and responsible, and thus encourage a "race to the bottom" where companies face pressure to adopt irresponsible practices to compete. This dynamic is one reason why parts of the small business financing market have been compared to the subprime mortgage market before the 2008 crisis.⁸ By providing guardrails that promote healthy competition instead of exploitation, rulemaking under 90009(e) can advance DFPI's dual mission of both financial protection *and* innovation.

In the following letter, we share stories of small businesses and nonprofits affected by predatory lending and provide examples of specific commercial UDAAP problems that DFPI could address. We also recommend that DFPI's data collection authority under § 90009(e) be used in conjunction with the rules that DFPI is promulgating under SB 1235, the first small business Truth in Lending law in the nation.

Also attached is a legal memorandum finding that DFPI has the power to enforce violations of UDAAP as defined in a rulemaking under § 90009(e), written by former CFPB Director and Supreme Court clerk Richard Cordray and California attorney Ed Howard, on behalf of the Office of Kat Taylor. The

⁵ Responsible Business Lending Coalition, "Re: Third Invitation for Comments on Proposed Rulemaking Commercial Financing Disclosures, File No: 01-18," January 31, 2020. See pages 2-3.

⁶ "Yelp: Local Economic Impact Report," September 2020. <https://www.yelpeconomicaverage.com/business-closures-update-sep-2020.html>

⁷ Fairlie and NBER, University of California, Santa Cruz, "The Impact of Covid-19 on Small Business Owners: Evidence of Early-Stage Losses from the April 2020 Current Population Survey," May 2020. <https://siepr.stanford.edu/sites/default/files/publications/20-022.pdf>

⁸ See, e.g. Shin, Laura, Forbes, "Why Online Small Business Loans are Being Compared to Subprime Mortgages," Dec 2015. <https://www.forbes.com/sites/laurashin/2015/12/10/why-online-small-business-loans-are-being-compared-to-subprime-mortgages/#1afdbb592889>

memorandum also includes suggested language for the § 90009(e) rulemaking, to support DFPI in proceeding quickly to initiate the protections small businesses need.

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Accounts of California Small Businesses and Nonprofits Victimized by Predatory Financing

Several small business owners were brave enough to share their stories of predatory lending for inclusion in this comment. Most of the business owners sharing their stories are still in litigation, or undergoing bankruptcy, and asked that their names remain anonymous. Jim Cook, leader of Antelope Valley Community Health, offered to go on record to share the story about the rise and eventual sale of the clinic due to predatory lending.

Lancaster, California: Antelope Valley Community Clinic

When Jim Cook and other community members came together to start a mobile healthcare clinic in Antelope Valley, California, Mr. Cook had been doing community work for decades. The Antelope Valley Community Clinic opened as a solution to the lack of primary care services for the underinsured and uninsured in the Antelope Valley, which spans over 2,000 square miles and has over 480,000 residents. Antelope Valley also has some of the poorest health indicators in all of Los Angeles County including diabetes, infant mortality, and obesity, congestive heart failure, asthma, and others.⁹ The mobile clinic Jim ran became the only clinic available in the area. Almost all of the patients were MediCal recipients or uninsured, and would otherwise use emergency room services when they needed care.



The ribbon cutting celebrating the opening of the Antelope Valley Community Clinic branch in East Palmdale.

⁹ Antelope Valley Community Updates and Events, “Antelope Valley Community Clinic,” <https://www.antelopevalley.com/antelope-valley-community-clinic.html>

By 2010, the clinic had expanded to several offices and an operating budget of \$3 million, while employing 245 staff members. To finance taxes that were due during this period of expansion, they took a MCA from a company that reached out offering to help.

After the deal was signed, the financing company delayed disbursement of the funds but began collecting payment. As the Community Clinic's finances became tighter and fell behind on its MCA payments, they took a second MCA that was offered to help pay for the first. This led to a third, and fourth MCA, in a debt-trap cycle of borrowing to repay unaffordable debt.

The financing company set this trap using a series of UDAAP practices sometimes deployed together in the high-rate small business financing industry. It began with a payment beyond the clinic's ability to pay, and a lack of transparent disclosure that could have helped Mr. Cook and his colleagues better evaluate the financing offer.

First, the financing companies repeatedly delayed disbursement of the needed funds, inclining the clinic to fall into delinquency. Once delinquent, the clinic was required to negotiate from a desperate position where it would be more willing to accept abusive terms.

Second, the financing companies flipped the clinic through multiple loans, each time generating new fees. Having led the clinic into a more desperate situation, the financing company promised a better deal, at a lower rate, if the clinic would refinance. This generated new fee income for the financing company each time, and increased their annualized returns by accelerating repayment. MCAs generally require repayment of a fixed amount that does not decrease if the financing is paid off earlier. So if the MCA is refinanced as repaid in half the expected time, the MCA company's annualized yield doubles.

Third, each time the new financing is used to repay older financing, the borrower can be "double dipped." This term is used in the high-rate small business financing industry to refer to double charging a borrower during a refinance.

The churn from one financing transaction to the next sometimes ends when the financing company decides the borrower cannot be squeezed further and that it is time to get out. In a practice called "carroting," they may offer one last great financing deal as a "carrot," if the borrower will just pay off the outstanding MCAs in order to qualify. That final "carrot" is never delivered, but it enables the financing company to walk away whole from the financially-drained business.

In this case, the Antelope Valley Community Clinic was already too drained to pay. And so the MCA company shifted to collections. MCA company representatives drove across the East Coast contacting the various sources of the clinic's revenue, collecting thousands from various pharmacies contracted with Antelope Valley Community Clinic.

The MCA company also attempted to take funds from Mr. Cook's personal account. Fortunately, they were unsuccessful, as Mr. Cook's community bank refused. Had the bank not protected Mr. Cook, he could have lost his home.

To try and recover, the Antelope Valley Community Clinic laid off about 25 staff members and shrank substantially by outsourcing several activities. It wasn't enough. Ultimately, the clinic had to be sold to a larger healthcare provider.

In a seven-month period, Antelope Valley Community Clinic paid out over \$2.2 million to the MCA company for an original financing amount of \$1.2 million. While we do not know the cadence of payments, if we assume the payments were made in equal amounts over that period, the APR would compute to 233%.

San Diego, California: Emergency response software company

A San Diego-based company building emergency response software had a similar story to tell. Their software helps emergency medical services and fire departments respond to crises more efficiently. The company employed 45 workers.

Several years ago, the business owners' accounting firm referred them to a loan broker. They sought out more traditional financing, but were denied. The broker recommended a merchant cash advance. In some correspondences, the broker advised the business owner that signing the contract with an MCA was a "big step towards better lending" with a "real bank". In one instance, the broker said that he would walk the small business owner to the front door of a brick-and-mortar bank.

Almost immediately after receiving the advance, the broker advised that they could receive a repackaged loan at better rates. The small business owner agreed to take the second advance of \$2.3 million. The broker earned a 10% commission of \$230,000. This practice of brokers loading up a small business with multiple loans or refinances sometimes called "stacking."

The second advance never came, though payments against it were deducted. In a matter of weeks, the software business was behind in payments. The contract they signed with the MCA company kept the software company from seeking more affordable capital elsewhere. There were "non-circumvention clauses" which dictated that the small business could not pay other financing companies for a certain time period (this can be years). If the small business violated this clause and obtained financing from a different company, the contract dictated that they would be subject to additional fees.

By 2019, the small business had paid \$1 million in interest. Throughout this time, the small business described being called constantly by the broker, asking her to send funds to different companies under the auspices of a payment they owed. Ultimately the small software business received only \$600,000 out of \$2.35 million they had paid for.

California: Thirty-three African American Churches

Predatory financing can affect nonprofits and churches as well as small businesses. A particularly stark example was the abuse by two lease financing companies of 193 black churches in fifteen states. Thirty-three of these churches were in California.

According to lawsuit filed in 2011 by then-Attorney General Kamala Harris,¹⁰ as summarized by BET:

“Two Maryland-based companies—Urban Interfaith Network (UIN) and Television Broadcasting Online (TVBO)—promised 193 black churches in 15 states that they would provide technologically advanced computer kiosks that would connect the churches to high-profile advertisers who would not only pay for the full cost of the kiosks and generate new revenue, but also bring the churches ‘into the 21st century.’

When the ‘kiosks’ arrived, however, they were normal desktop computers mounted onto cheap wooden podiums, and they very often didn’t work the way they were supposed to, according to the lawsuit. What’s more, once the kiosks were installed, the checks supposedly coming from benevolent companies to pay the leases on the machines began arriving late, if at all, forcing the churches to foot the bill—sometimes to the tune of more than \$47,000. When the churches couldn’t afford or refused to pay the leases, Balboa Capital Corporation and United Leasing Associates of America, the leasing companies behind the kiosks scheme, sued the churches for the funds.

It probably won’t surprise you to know that two TVBO and UIN employees named in Harris’ suit, Willie Perkins and Michael Morris, are currently in prison in Michigan for scamming dozens of churches in that state. Two others, however, Wayne and Tanya Wilson, supposedly reside in Rancho Cucamonga, California...

The saddest irony, it would seem, is that venues of faith were penalized for having that faith in their fellow man.”¹¹

This predation may be continuing. As of 2020, the same leasing company, Balboa Capital, was suing Pure Word Missionary Baptist Church in the Orange County Superior Court.¹²

This also suggests that, as a financial regulator, DFPI can complement the enforcement actions of the Office of the Attorney General by bringing a focus on establishing ongoing responsible market behavior in financial services.

¹⁰ Harris, Verdugo Jr., Sierra, and Bass, Supreme Court of the State of California, County of Los Angeles, “COMPLAINT FOR RESTITUTION, CIVIL PENALTIES, INJUNCTION AND OTHER RELIEF FOR VIOLATIONS OF BUSINESS AND PROFESSIONS CODE SECTIONS 17200 AND 17500 (UNFAIR COMPETITION AND FALSE ADVERTISING LAWS),” Feb 2011. https://oag.ca.gov/system/files/attachments/press_releases/n2042_complaint.pdf

¹¹ Jefferson, BET, “California Goes After Church Scammers,” March 2011. <https://www.bet.com/news/national/california-goes-after-church-scammers.html>

¹² Southern California Record, “Case activity for Balboa Capital Corp. vs Pure Word Missionary Baptist Church on Aug. 19,” Aug 2020. <https://socalrecord.com/stories/549240185-case-activity-for-balboa-capital-corp-vs-pure-word-missionary-baptist-church-on-aug-19>

Marin County, California: Woman-owned wine company

One business owner shared a story of a wine company she has owned with her husband since 1976. Business was strong, until the company ran into a temporary issue with their shipper, impacting their ability to ship wine cross-country. Shipping costs tripled overnight and the business was suddenly unable to fill the existing orders. The shipping issue would be resolved months later.

In a crunch, she reached out to their existing bank and was denied. A friend put them in touch with a merchant cash advance company. While the couple had a sense that the financing would be expensive, she shared they did not fully understand the amount they would end up paying for the emergency cash. Only after the deal was signed, and the winery's payments amounted to approximately \$30,000/day, including exorbitant fees for services never rendered, did it become clear how unaffordable this financing was.

Unable to pay, she and her husband fell into default. The financing company quickly exercised liens on all of the business's credit card processors, which cut them off from any future revenue. The financing company also placed liens on their personal and business bank accounts. At one point, subsequent litigation describes that a staffer from the financing company impersonated her husband when contacting his personal bank in order to place a lien on the personal account. Without legal defense, both their business and their personal finances could have been destroyed.

RFC Q6: Unfair, Deceptive, and Abusive Acts or Practices (UDAAP) in Small Business Financing

In the request for comment, DFPI asks:

“6. Unfair, Deceptive and Abusive Acts and Practices (Commercial)

Are there specific acts or practices in the commercial financing market or in the offering and the provision of financial products or services to small business recipients, nonprofits, and family farms that stakeholders believe are unfair, deceptive, or abusive?... (Fin. Code § 90009, subd. (e).)”

The RBLC urges DFPI to issue a regulation under 90009(e) as soon as possible to define UDAAP for commercial financing. At stake is the stability of California's middle class, the ability of immigrant and low-wealth communities to join that middle class, the widening of the racial wealth gap, the destruction of the local character of California's cities and towns, and the loss of local jobs.

This rulemaking should include brief language and begin immediately, irrespective of related rulemakings in process. In fact, suggested language for a small business UDAAP rule is included in the attached memorandum by Mr. Cordray and Mr. Howard. This suggested language is three sentences long, and simply confirms that the existing definitions of unfair, deceptive, and abusive in California law apply to financing of small businesses, nonprofits, and family farms:

“Amend Title 10, Chapter 3, Subchapter 6, Article 1, section 1404 of the California Code of Regulations (“Definitions”) as follows:

(m) (1) “Unfair, deceptive, and abusive” acts and practices as used in Financial Code section 90009(e) in connection with the offering or provision of commercial financing, as defined in subdivision (d) of Section 22800, or other offering or provision of financial products and services to small business recipients, nonprofits, and family farms are prohibited.

(2) “Unfair, deceptive, and abusive” acts and practices, as used in Financial Code section 90009(e), may include any act that is unfair or deceptive under the Unfair Competition Law, Business & Professions Code section 17200, et seq., and case law thereunder, as interpreted by the California Supreme Court or in a published decision of the California Court of Appeal.”

The memorandum attached provides a detailed discussion of this language, its enforceability, and includes suggested language for an initial statement of reasons as well.

As evident in the suggested rule language above, we believe the DFPI should not define specific practices as UDAAP, but instead reference the longstanding and definitions of unfair, deceptive, and abusive that exist today under the Dodd-Frank Act, the California Unfair Competition Law, and the Federal Trade Commission Act.

Predatory practices evolve constantly, and only clear, broad definitions of UDAAP will enable DFPI to protect small businesses, nonprofits, and family farms from newer practices that emerge. Indeed, monitoring emerging practices is the special task of the DFPI, and not possible if UDAAP rules are limited to specific acts or practices.

Below are several of the specific UDAAP issues that DFPI could pursue under such a principles-based UDAAP rule.

A. Mischaracterizing financing as not being credit to evade lending laws

The CCFPL § 90009(e) is wisely written to cover “commercial financing” of all types, including products that are not loans such as some MCAs and factoring. In some cases, products that should be considered loans are sold as if they are not. This sort of evasion of lending law is one of the broad categories of regulatory gaps that DFPI was created to address, across consumer and small business financing. In fact, where these practices are unaddressed in small business financing, they may soon find their way into consumer financing.

DFPI has grappled with this evasion issue admirably in its recent consent order with MCA company Allup Finance.¹³ The RBLC commends DFPI for this excellent work. A UDAAP rulemaking would give DFPI additional, and potentially broader powers, to address this sort of unfair practice.

B. Failing to comply with SB 1235 Truth-in-Lending rules, including by non-licensees

DFPI has led the nation in establishing Small Business Truth in Lending rules under SB 1235, enacted in Division 9.5. Indeed, DFPI’s draft rules have inspired specific language in the New York Small Business

¹³ Smith, O’Donnell, and Ross, State of California - Department of Financial Protection and Innovation, “Consent Order,” Nov 2020. <https://dfpi.ca.gov/wp-content/uploads/sites/337/2020/11/Consent-Order-Allup-Finance-LLC.pdf>

Truth in Lending Act passed in 2020, and similar legislation is now being considered in Maryland, Connecticut, and at the federal level.

Unfortunately, DFPI's rules will not effectively protect small businesses if they are only enforceable against licensed financing companies. But a UDAAP rulemaking under § 90009 would clarify enforcement of Division 9.5 on unlicensed firms, which would include much of the merchant cash advance industry and other segments of the market that the Federal Reserve describes as "potentially higher-cost and less-transparent credit products."¹⁴ After all, this is where DFPI's enforcement of SB 1235 is needed most.

Section 17200 of the Business and Professions Code defines unfair as follows: "unfair competition shall mean and include any unlawful, unfair or fraudulent business act or practice and unfair, deceptive, untrue or misleading advertising..."¹⁵ Any violation of Division 9.5, whether or not it is enforceable through powers described in Division 9.5, can thus be enforceable through Section 17200. If a violation of Division 9.5 by a nonlicensee is "deceptive" or "misleading," or even simply, "unlawful," it would be considered "unfair competition" under Section 17200.

C. Quoting pricing in misleading ways outside of the required SB 1235 disclosure

Federal Reserve research has repeatedly established that some common pricing metrics used today are misleading. The Department should clarify that these misleading practices are not permitted.

The Federal Reserve research has established that certain metrics, such as "simple interest," "fee rate," and "factor rate" are misunderstood by borrowers to be the interest rate or APR, when in fact they are generally much lower numbers than the actual interest rate or APR. We have little doubt that these metrics are used to mislead small businesses into believing that high-cost financing is less expensive than it truly is. A 2018 Federal Reserve study describes the confusion:

- **Participants were confused by terminology used to describe all three products.** For Product A, "repayment percentage options" was a confusing term for some participants who thought this was an interest rate, rather than a share of sales. For Product B, participants most commonly conflated "simple interest" with the APR. In addition, the phrasing of the statement "this rate *excludes* any fees, *including* a one-time origination fee of 3%" (emphasis added) perplexed some participants. For Product C, the term "factor rate" was the main source of confusion for a majority of participants who stated they had not heard it before.

In short, small businesses often understood any number described in percentage terms to be the interest rate or APR.¹⁶

A 2019 follow-up study by Federal Reserve researchers found that "non-standard terminology" used by some alternative lenders "proved challenging for focus group participants trying to compare online

¹⁴ Zeeuw, Mels de, Federal Reserve Bank of Atlanta, "Small Business Credit Survey: Report on Minority-Owned Firms," Dec 2019. <https://www.fedsmallbusiness.org/medialibrary/fedsmallbusiness/files/2019/20191211-ced-minority-owned-firms-report.pdf>

¹⁵ California Legislative Information, "Law section," 1993. https://leginfo.ca.gov/faces/codes_displaySection.xhtml?sectionNum=17200.&lawCode=BPC

¹⁶ Lipman, Barbara and Wiersch, Anne Marie, Federal Reserve Board of Governors, "Browsing to Borrow: 'Mom & Pop' Small Business Perspectives on Online Lenders," June 2018. <https://www.federalreserve.gov/publications/files/2018-small-business-lending.pdf>

offerings with traditional credit products.”¹⁷ The following table from that study illustrates the severity of this confusion. In the left column, the “non-standard terminology” is displayed. As you can see below, the price number presented on the left is markedly lower than the actual APR noted in the right column.

| Table 3. Estimated APRs for select online products | | |
|---|---|--------------------------|
| Rate advertised on website | Product details | Estimated APR equivalent |
| 1.15 factor rate | <ul style="list-style-type: none"> • Total repayment amount \$59,000 • Fees: 2.5% set-up fee; \$50/month administrative fee • Term: none (assume repaid in six months) • Daily payments (assume steady payments five days/week) | Approximately 70% APR |
| 4% fee rate | <ul style="list-style-type: none"> • Total repayment amount \$56,500 • Fee rate: 4% (months 1–2), 1.25% (months 3–6) • Fees: none • Monthly payments • Term: six-month term | Approximately 45% APR |
| 9% simple interest | <ul style="list-style-type: none"> • Total repayment amount \$54,500 • Fees: 3% origination fee • Weekly payments • Term: six-month term | Approximately 46% APR |
| Source: Authors’ calculations, based on product descriptions on company websites. | | |

Each of these “non-standard” metrics in the left column is, in fact, the same metric by a different name. It is a financing charge as a fraction of the financing amount. A more common term for this metric is a “fee.”

The first example in the table above, the “1.15 factor rate,” is more commonly understood as a 15% fee. The second example, a “4% fee rate,” would be more commonly understood as a 4% fee charged monthly. The third example, “9% simple interest,” is a 9% fee. It bears little resemblance to the interest rate, which would be 34%. (Combining that 34% effective interest rate with the 3% origination fee produces the 46% APR).

DFPI should address the misleading disclosure of fees as “non-standard” rates as a deceptive practice, and pursue it through UDAAP enforcement. As you know, existing federal UDAAP regulation establishes that:

“A representation, omission, actor practice is deceptive when:

- (1) The representation, omission, act, or practice misleads or is likely to mislead the consumer;
- (2) The consumer’s interpretation of the representation, omission, act, or practice is reasonable under the circumstances; and
- (3) The misleading representation, omission, act, or practice is material.”¹⁸

¹⁷ Lipman, Barbara and Wiersch, Anne Marie, Board of Governors of the Federal Reserve System, “Uncertain Terms: What Small Business Borrowers Find When Browsing Online Lender Websites,” Dec 2019.
<https://www.federalreserve.gov/publications/files/what-small-business-borrowers-find-when-browsing-online-lender-websites.pdf>

¹⁸ Consumer Financial Protection Bureau, “Unfair, Deceptive, or Abusive Acts or Practices,” Oct 2012.
https://files.consumerfinance.gov/f/documents/102012_cfpb_unfair-deceptive-abusive-acts-practices-udaaps_procedures.pdf;

We also encourage the DFPI to address this practice within SB 1235 rulemaking, which may be a faster, more consistent way, when compared to enforcement litigation, to ensure transparent disclosure practices across the market for small businesses.

Double dipping occurs when a small business refinances or renews their financing with their current provider, and the proceeds from the new loan or advance is used to pay off the balance from the previous loan or advance, including any unpaid or un-accrued interest or fees. In this way, the provider charges the borrower the same fixed-fee twice for the balance that was outstanding. The fixed fee is charged once as the outstanding balance is paid off, and then a second time for the same capital in the renewal.

The cartoon illustrates the concept of 'double dipping' through a series of financial transactions. It begins with a man thinking about money, represented by a thought bubble with a dollar sign. A clock shows the time passing. A man looks at a sign that says 'FULL PRICE!?' with a surprised expression. Another man is shown using a machine that adds fees, with a speech bubble saying 'USE THE NEW FUNDS TO PAY OFF THE \$5K'. A third man is counting money, with a speech bubble saying '\$6000 COST FOR \$15,000'. The illustration includes several bags of money with labels: '\$10K 30% FEE', '\$13K', '\$5K', '\$10K', and '\$13K'. A speech bubble says '30% FEE' and another says 'ANOTHER 30% FEE!'. The text 'DOUBLE DIPPING!' is written in large, bold letters. The cartoon is signed 'HEH HEH HEH!' in the top right corner.

https://www.ftc.gov/system/files/documents/public_statements/410531/831014deceptionstmt.pdf

https://leginfo.ca.gov/faces/codes_displaySection.xhtml?sectionNum=17200.&lawCode=BPC

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This “three card monte” concealment of charges fits clearly within the definition of “abusive” that appears in the Dodd-Frank Act, and is referred to in section 90009(c)(3) of the CCFPL, if the term “consumer” is replaced with “customer” to include small businesses, nonprofits, and family farms:

“An abusive act or practice:

- Materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or service or
- Takes unreasonable advantage of:
 - A lack of understanding on the part of the consumer of the material risks, costs, or conditions of the product or service;
 - The inability of the consumer to protect its interests in selecting or using a consumer financial product or service; or
 - The reasonable reliance by the consumer on a covered person to act in the interests of the consumer.”²¹

This practice of double dipping could similarly be described as unfair or deceptive.

E. “Carroting” borrowers into prepaying using false promises

“Carroting” is a high-rate financing industry term for inducing a small business to pay off a prior agreement with a false promise of new funding, perhaps at better terms. Once the small business scrapes together financing to pay off the prior agreement, the promised new financing offer evaporates. This deception allows the financing company to get out “whole.”

The practice is described by one merchant cash advance company executive:

“I was approached by a young employee with a smart idea for collections that he claimed would greatly improve our recovery rate. He suggested calling defaulted merchants and promising them new funding under a fake MCA funder name. After getting all their information, he would claim that they were eligible for greatly expanded funding if only they would pay off the defaulted Pearl funding. Of course, that fictional funding would never occur. I explained to him that although I would love to improve our recovery rates, what he suggested was unethical and we wouldn’t adopt it. When he persisted in advocating for it, I fired him.

I recently spoke with a merchant who was promised \$100k in funding with \$25k from Pearl and an additional \$75k at favorable terms from a second funder that would co fund. A fake contract

²¹ Title X of the Dodd-Frank Wall Street Reform and Consumer Protection Act (12 U.S.C. Sec. 5481)

was created from a fictitious funding company and of course the funding for the additional \$75K never occurred. This practice actually has acquired an industry name ‘carroting’.”²²

This MCA executive advocated for “Requiring licensing, bonding, and disclosure of broker fees.”²³

Small business owners described similar experiences of financing companies dangling false offers to encourage refinancing, with new fees and double dipping.

F. Using “doing business as” names to conceal a lender’s identity and avoid accountability for abuse

Some high-rate financing companies operate under multiple assumed names so that the small business owner does not know who they are truly dealing with. One woman, who owns a commercial interiors contractor, summarized her experience saying, “Some of these companies aren’t even really financing companies. They’re stealing companies. They offer financing, but stealing is their product.”

In this small business owner’s account, the financing company used misleading identities in a “good cop, bad cop” charade to pull her through the string of multiple refinances. It began when the financing she agreed to was disbursed in less than the agreed-upon amount, As her financial situation became more desperate, a new individual contacted her purporting to represent a different company.

“I hear you’re working with ABC company,” she described being told. “Those guys have a terrible reputation for ripping off small businesses. They’re a scam. I want to help you though. I can offer a new advance to get you out that mess.” When she took the new advance, the same cycle would start over until another purported savior would call.

As she learned more years later through litigation, she began to suspect that this string of “good cop” and “bad cop” salesmen had actually been sitting just cubicles apart. The company names they had given were in fact “doing business as” names that ultimately belonged to the same financing company.

Because the business names used were “doing business as” shell names, the financing company was able to escape accountability from complaints to the Better Business Bureau or social media reviews, or and even nearly avoided litigation. One after another, these fake front companies simply stopped returning calls and emails, leaving no way for her to get in touch, and vulnerable to the “good cop” act from the next salesman who may have been two cubicles down.

To execute this deception, the “doing business as” names used may be very similar to the name of a truly different company, to create the false appearance of representing that other company.

Several UDAAPs may be employed together. In this example, each time the small business owner was misled into refinancing, they very likely were also “double dipped.” This practice of double charging fees,

²² Sol Lax, Pearl Capital “What the Bloomberg and Yahoo Articles Get Wrong About MCA,” December 2018.

<https://pearlcapital.com/mca-sales-tools/newsletters/what-the-bloomberg-and-yahoo-articles-get-wrong-about-mca/>

²³ *Id.*

described above, is even more insidious when the small business owner does not know the two financing transactions are with the same company.

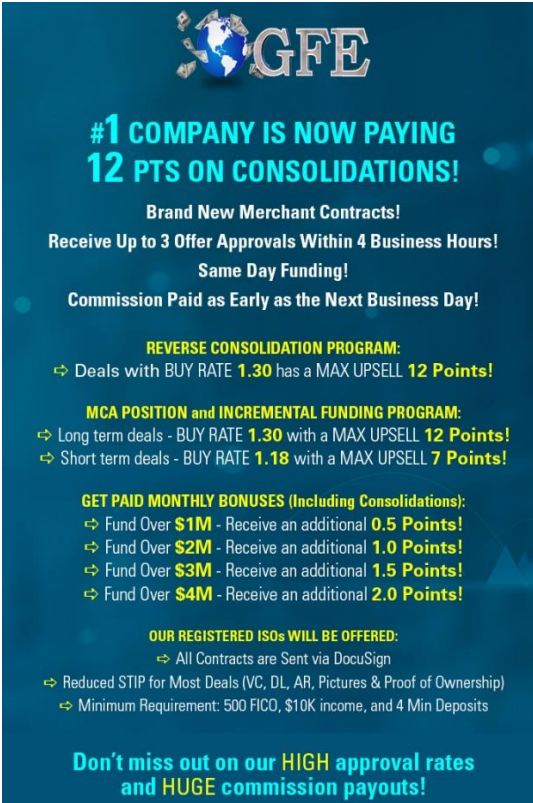
G. Advancing less than the financing amount to apply pressure

Several small business owners described how the predation of their companies began when the financing company disbursed less than the agreed-on amount. In some cases, the financing company began deducting payments in full nonetheless. Without use of the full financing proceeds they had been counting on, these small businesses were forced into an even more vulnerable situation, seeking more financing from a position of desperation, subjected to arbitrary fees, high pricing, and being “double dipped” along the way.

A similar trick includes a last-minute change in terms to disbursement of the financing in installments. Each installment is contingent on the now-more-desperate business owner making the required payments. This small business owner never gets the cash flow benefit they anticipated from a lump sum disbursement. In a sense, they may be simply accruing financing charges while the money comes in and out, without actually receiving the capital they needed.

H. Brokers steering borrowers into products that pay high, hidden fees to brokers

Some financing companies seek to attract customers not by providing the best prices permitted by their cost structure, but by charging prices high enough to pay brokers “HUGE commission payouts!” to quote an October 2020 advertisement included below:



GFE

#1 COMPANY IS NOW PAYING 12 PTS ON CONSOLIDATIONS!

Brand New Merchant Contracts!
Receive Up to 3 Offer Approvals Within 4 Business Hours!
Same Day Funding!
Commission Paid as Early as the Next Business Day!

REVERSE CONSOLIDATION PROGRAM:
⇒ Deals with BUY RATE **1.30** has a MAX UPSELL **12 Points!**

MCA POSITION and INCREMENTAL FUNDING PROGRAM:
⇒ Long term deals - BUY RATE **1.30** with a MAX UPSELL **12 Points!**
⇒ Short term deals - BUY RATE **1.18** with a MAX UPSELL **7 Points!**

GET PAID MONTHLY BONUSES (Including Consolidations):
⇒ Fund Over **\$1M** - Receive an additional **0.5 Points!**
⇒ Fund Over **\$2M** - Receive an additional **1.0 Points!**
⇒ Fund Over **\$3M** - Receive an additional **1.5 Points!**
⇒ Fund Over **\$4M** - Receive an additional **2.0 Points!**

OUR REGISTERED ISOs WILL BE OFFERED:
⇒ All Contracts are Sent via DocuSign
⇒ Reduced STIP for Most Deals (VC, DL, AR, Pictures & Proof of Ownership)
⇒ Minimum Requirement: 500 FICO, \$10K income, and 4 Min Deposits

Don't miss out on our HIGH approval rates and HUGE commission payouts!

In this advertisement, the financing company offers brokers “12 PTS ON CONSOLIDATIONS!” (It is not clear how this financing “consolidation” could save a customer money if it includes a 12% fee.)

The advertisement goes on to offer brokers “MAX UPSELL 12 Points!” In other words, the broker is permitted to “upsell” the borrower, increasing the price actually presented to the borrower by up to 12% of the loan amount, without telling the borrower they have added this fee.

The “buy rate” described above is “1.30,” representing a financing fee of 30%. The broker may add 12 points and present the offer to the borrower as if the price were 1.42, representing a financing fee of 42%. The 12 point commission markup is hidden from the borrower--they likely do not know they have been “upsold.”

The fee has no relationship to the borrowers’ creditworthiness. This same practice in subprime mortgage lending, called “yield-spread premiums,” has been cited as a cause of fraud and racial discrimination in the subprime mortgage lending market, and has been subject to Congressional limits and regulatory sanction.²⁴

Text accompanying this advertisement further explains, “You heard it right... 12 POINTS! ... but why stop there? ... if you want to also earn up to 2 additional points based on your total monthly funding amount (including Consolidations), then start working your way up our MONTHLY VOLUME BONUS structure to maximize your earning potential.”

Making explicit that this is an effort to avoid competition in a manner that raises prices, instead of beating competition by lowering prices, the accompanying text continues: **“With a deal this good, why would you even consider submitting your deals elsewhere?”**

Other financing companies entice brokers with a golden, rotating image promising “15 POINTS,” representing a 15% commission fee. The more volume the broker steers to this particular financing company, the higher their commission. “EARN UP TO 19 POINTS!” the financing company proclaims.

15 POINTS
EVEREST

STILL PAYING 15 POINTS EVERYDAY!

PLUS GENEROUS MONTHLY BONUSES
EVERY MONTH!

TIME TO BUILD YOUR MARCH BONUS:

| | | | |
|-------------------|--------------------|----------------------|----------------------|
| 24 DAYS | 16 HOURS | 35 MINUTES | 24 SECONDS |
|-------------------|--------------------|----------------------|----------------------|

FUND:
\$250k = 1% BONUS
\$500k = 2% BONUS
\$750k = 3% BONUS
\$1 Million = 4% BONUS

Bonus is based on funded + renewal amount each month.

**SEND ALL YOUR DEALS TO EVEREST
EARN UP TO 19 POINTS!**

²⁴ See, e.g. Consumer Financial Protection Bureau, “CFPB and Department of Justice Take Action Against Provident Funding Associates for Discriminatory Mortgage Pricing: Harmed African-American and Hispanic Borrowers Will Receive \$9 Million,” May 28, 2015. <https://www.consumerfinance.gov/about-us/newsroom/cfpb-and-department-of-justice-take-action-against-provident-funding-associates-for-discriminatory-mortgage-pricing/>

This steering incentive leads brokers to place small businesses into products that may be their least-suitable, most expensive option, and then add hidden charges to those already expensive products.

A broker may spend several weeks working with a small business to access an SBA loan and earn a 1% fee. They may spend a day working with that business to obtain an unsecured loan and earn 2%. Or they might spend an hour steering that business into an expensive MCA or term loan and earn 15%. One can imagine the result.

I. Broker-driven “flipping” and fee churning

These hidden commission fees can incentivize brokers to “churn” small businesses through multiple financing transactions. The broker can rack up a new commission each time, and may also charge their own additional fee to the borrower for their services. The high-fee refinancing practices recall the “equity-stripping” practices of pre-2008 subprime mortgage markets.

Deceptive practices may be used to assist this churning. Broker commission fees in the merchant cash advance industry are sometimes subject to a “claw back” if the merchant defaults within a certain period, often the first twenty payments. Brokers use false promises of an SBA loan or more permanent financing to encourage a small business to comply with the agreements for the first twenty days, encouraging the business to do whatever is necessary to make the payments over the first twenty days. After twenty days, no permanent financing materializes.

Alternatively, the broker may flip the small business into another short-term financing contract, to pay off the first contract and insure collection of the commission fee. These early repayments generate significant additional cost for the borrower, and fee income for the broker and financing company, because these short-term financing products generally require repayment of the full financing amount, or something

close to it, even if the financing is prepaid. In the end, the small business may find themselves in a cycle of debt without any knowledge that the broker has taken advantage of them to earn a commission.

The financing company advertisement below assures brokers, “No Revenue? No Worries!” However, should the incentives created by a “25% commission” paid to brokers give DFPI pause?



NO REVENUE? NO WORRIES!

WE'LL GET STRAIGHT TO THE POINT
THIS YEAR, WE ALL NEED A BOOST

HOW ABOUT:

- \$10,000 - \$100,000
- 0% interest for 9-24 months
- Low Monthly Payments (like, really low)
- 25% commission

Other merchant cash companies may forgo this “clawback” requirement for creditworthiness altogether:



GFE

No Commission Clawback

On Deals Funded After 2/8/21*

Don't Miss out on our HIGH Approval Rates
and HUGE Commission Payouts!

J. “Stacking” of multiple sales-based financing products

Encouraging a small business to take multiple sales-based financing deals simultaneously is sometimes known in the industry as “stacking.” It can be deleterious for a small business.

Sales-based financing commits a small business to paying the financing company a fixed percentage of each dollar in sales earned. This “split rate” percentage typically ranges from 2% to about 25% of the business’s sales. Compare this percentage to typical profit margins of small businesses. Tax preparers were the highest profit-margin small business industry, according to a 2017 report by accounting software company Sageworks, and earned a profit margin of 18.4%.²⁵ Real estate agents, another industry that avoids significant operating expenses like inventory, high staffing costs, and rent, earned 14.3%. Grocers earned 2.2%, wine and liquor stores earned 2.4%, and restaurants earned 6%.²⁶ The diversion of 2% to 25% of gross revenue to the sales-based financing company, for just one sales-based financing product, may well drive these businesses into unprofitability.

In fact, the average high-rate business financing product *does* drive its borrower into unprofitability, according to a study of California small businesses by Accion Opportunity Fund. Analysis of over one hundred financing contracts found that the average payment represented 178% of the business’s available net income.²⁷ In other words, the *average* financing contract in this higher-cost category charged almost double what the small business could afford.

Now consider the effect of multiple sales-based financing contracts simultaneously. If a business owner from the most profitable industry, tax preparation, took three sales-based loans or MCAs, and each one diverted 10% of the gross sales revenue coming in the door, the business owner's profit margin has fallen to -11.6%. Continuing operations may become difficult or impossible. Some business owners may seek to borrow their way out, and risk falling deeper into a debt trap.

Stacking may become a UDAAP concern in part because of questions about the legality of multiple contracts. If a merchant cash advance is a purchase of future receivables, multiple advances could

²⁵ Steve Nicastro, “Profit and Loss: Why Some Industries Fare Better Than Others,” Nerdwallet, October 24, 2017. Accessed at: <https://mainstreetlaunch.org/profit-loss-industries-fare-better-others/>

²⁶ *Id.*

²⁷ St. Louis, Weaver, Donaker Brown, and McShane, Opportunity Fund, “Unaffordable and Unsustainable: The New Business Lending on Main Street,” May 2016. <https://www.opportunityfund.org/blog/unaffordable-and-unsustainable-new-opportunity-fund-report/>

represent the purchasing the same receivables multiple times. If a finance company knows they are entering into an invalid contract, this may constitute unfair competition.

One merchant cash advance provider wrote that “the failure rate for business owners who take a third merchant cash advance is 100% based on our direct experience of working with these business owners.”²⁸

In the advertisement below, one sales-based financing company advertises their willingness to fund in “1st-4th position,” meaning that they would provide a cash advance to a small business already repaying three different cash advances.



**What is at the end of
your rainbow...**

- **FAST and SIMPLE process**
 - **Same day funding**
 - **Fast approvals**
 - **1st-4th position**

**If you are not a partner with us please
contact us and let's go**

J. Misleadingly marketing short-term products for long-term use

Consumer payday lending is reviled for purporting to offer short-term cash to cover emergencies, while often operating in a business model built on encouraging long-term use of the financing. Some short-term small business financing operates the same way.

Stated marketing claims of short-term small business financing providers can present a high-cost loan as a solution for a short-term emergency. Some examples of product use that financing companies have marketed online have included a pizza shop repairing a broken pizza oven, and a catering company using short-term capital to buy ingredients for a large event just days away. Because the financing is short-term, these examples indicate, it is appropriate to pay an annualized rate that is higher than the profit margin of the business. After all, the cost won't really be annual.

At the same time, these companies may have a stated business practice of encouraging borrowers to use the purportedly short-term financing on an ongoing basis. For example, a short-term lender may employ an inside-sales team with a standard operational practice of calling borrowers before payoff and

²⁸ Ballentine, Jay, “Stacking: Merchant Cash Advance Funders Jeopardize Main Street” February 3, 2014. Buynance. <http://archive.is/K190X>

encouraging them to renew their financing.²⁹ This may be written in procedure manuals and evident in scheduled sales call notification ticklers in the calendars of sales agents.

One financing provider had advertised the long-term use of their short-term product as a sign of borrower satisfaction: “Approximately 90% of our Merchant Cash Advance clients participate in the program more than once. In fact, the average customer renews about ten times!” The head of marketing for another short-term financing provider explained, “Our goal is to become a permanent part of the customers’ balance sheet.”

California’s Unfair Competition Law, Business & Professions Code section 17200 prohibits “deceptive, untrue or misleading advertising.”³⁰

K. Charging exorbitant and arbitrary fees

Fees charged in some segments of the small business financing market do not reflect a finely-tuned, market equilibrium cost of doing business, but may be composed of arbitrary, unnecessarily high fees extracted through a lack of transparency. For example, an analysis of small business financing terms conducted by the Woodstock Institute found merchant cash advance companies charging fees such as:

- An \$399 “ACH fee,” which bears no resemblance to the low cost of conducting payments through ACH. Although the ACH payment process is almost entirely automated, many MCA agreements claim it is “labor intensive” and charge an exorbitant fee to cover the alleged costs. The RBLC has seen so-called “ACH fees” reach as high as \$1,995. In other occasions, the fee is charged as a percentage of disbursed amount, and can balloon into tens of thousands of dollars.
- A \$195 “UCC fee,” while the cost of filing a UCC lien in Illinois, where the small business borrower was located, is \$20.³¹
- A \$249 “risk assessment fee” in addition to a \$395 “origination fee.” It is not clear what cost was incurred by the financing company, and what service rendered to the small businesses, in exchange for the first fee but not the second.³²

Other fees of concern include:

- “Account management fee” - One troubled business shared with the RBLC a contract whose fine print included an “account management fee” which permitted the merchant cash advance company to double-charge the borrower one extra payment per month without applying that payment towards the amount the small business owed.³³

²⁹ See, e.g. Faux, Zeke, “Wall Street Finds New Subprime with 125% Business Loans,” Bloomberg, May 21, 2014.

³⁰ California Legislative Information, “Law section,” 1993.

https://leginfo.ca.gov/faces/codes_displaySection.xhtml?sectionNum=17200.&lawCode=BPC

³¹ See: UCC filing fee schedule published by the Illinois Secretary of State, available here:

https://www.cyberdriveillinois.com/publications/business_services/ucc.html

³² Woodstock Institute, “Analysis of Business Loan Terms,” July 2016. “https://woodstockinst.org/wp-content/uploads/2016/07/Woodstock_Analysis_of_Online_SB_Loan_Terms.pdf”

³³ That contract read: “Account Management Fee - At the end of each month, Merchant will pay to ROYAL BUSINESS GROUP LCC an Account Management Fee. This fee will not be applied towards the reduction of the Purchased Amount. This monthly fee will equal the average of all the payments received as a “Specified Percentage” of the Merchants settle amount for that Month.” Without this fee, the APR appears to be 490%. With this fee, it appears to compute to 542%.

- “Due diligence fee” - Another contract charged a 10% “due diligence fee,” and a \$495 origination fee *in addition* to a 50% financing fee. What additional service could have been rendered for this 10% “due diligence fee”?
- “Collateral monitor fee” - Although small businesses using merchant cash advances are solely responsible for generating and collecting the sales revenue which the MCA considers collateral, some MCA agreements include a monthly “collateral monitoring” fee that could end up being thousands of dollars.
- “Default fees” - Many MCA agreements charge “default fees,” in addition to default interest and collection costs imposed under the agreements.
- “Attorney fees” - Some high-rate financing agreements provide for the payment of attorneys’ fees based upon a percentage of the outstanding balance. As a result, merchants are often charged attorneys’ fees totaling tens of thousands of dollars for minimal legal costs.

These fees are characteristic of a broken market. Instead of healthy price competition driving prices towards market rates for services rendered, financing companies are freely charging California small businesses with abusive and arbitrary fees. DFPI must protect our communities by bringing price transparency and accountability for UDAAP practices to the small business financing market.

L. Abusing ACH withdrawal authority

We have heard reports of financing companies, documented in litigation, continuing to charge daily ACH withdrawals even after the full financing amount was repaid. Some financing companies may have a practice of continuing to deduct ACH payments until the small business recognizes the abuse and places a stop payment on the account.

M. Abusive collection practices

A California gym owner named Jay shared his story of abusive collection practices.³⁴ Jay has been a trainer for nearly 30 years. He had run a successful business before, and put all of his savings into opening a new gym.

Improvements needed to be made to the space. To finance some of the project, Jay went to a traditional lender to ask for a small business loan. He was turned away because but didn’t meet the revenue requirements, as a start up venture. Jay had received frequent phone calls from the merchant cash advance companies, offering to provide cash quickly. He took one to get the capital he needed to to invest in the gym.

After taking the financing, Jay was in an accident and broke his femur. He was unable to work for a time, but commercial rent needed to be paid at about \$6000/month.

Jay was able to keep up with the payments until COVID hit, and gyms were some of the first establishments to close in California. Soon, Jay’s revenue was insufficient to make the payments required

³⁴ Jay provided permission to use his first name, but otherwise asked to remain anonymous.

by his merchant cash advance. The financing company left threatening messages on his wife's phone, tracked down the information of his customers telling him about his debt. The MCA sent emails to clients of Jay's that the company would 'pursue' them to get the money they were owed. The effect on the gym was devastating.

N. Abusing UCC lien notices

One specific form of abusive collection practice involves abusing the Universal Commercial Code ("UCC") lien system. After a small business has defaulted, high-rate financing companies have been documented sending out hundreds of UCC lien notices to the small business owner's family, friends, relatives, and even the merchant's competitors. These lien notices purport to be an effort to collect collateral from the associates of the business owner receiving the notices. However, these are not truly attempts to collect upon the debt from the recipient of the notice, because the financing company cannot have any belief, reasonable or otherwise, that the recipients are account debtors of the merchant. Instead, these letters are plainly intended to humiliate the small business owner into repaying.

RFC Q7: Small Business Data Collection

CCFPL also gives DFPI power to collect data on small business financing. In the Request for Comments, DFPI asks:

"7. Data Collection and Reporting for Commercial Financing

Should providers of commercial financing and other financial products and services to small business recipients, nonprofits, and family farms be required to collect and report data to the DFPI? (Fin. Code § 90009, subd. (e).) If so, what data should the DFPI require to be collected and why?"

DFPI data collection is necessary for California's first-in-the-nation small business Truth in Lending rules under SB 1235 to work effectively. As RBLCLC observed in comment to DFPI on that rulemaking, data collection of the quoted vs. the actual retrospective terms must be undertaken to "Prevent merchant cash advances from low-balling their payment amounts and APRs."³⁵

Without data collection, merchant cash advance providers could disclose unreasonably low payment amounts and APRs, misleading small businesses without concern for consequence. CCFPL § 90009 AB 1864 provides the Department newly defined authority to address this problem.

Here is an example of a hypothetical report that we recommend the Department require providers to submit, reflecting one line per financing account:

³⁵ Responsible Business Lending Coalition, "RE: Commercial Financing Disclosures Rulemaking, File No. PRO 01-18," October 28, 2020. See pages 12-15.
http://www.borrowersbillofrights.org/uploads/1/0/0/4/100447618/10.28_rblc_letter_pro_0118_%E2%80%9393_commercial_financing_disclosures_sb_1235.pdf

| | A | B | C | D | E | F | G |
|----|--------------------|------------------|----------------------------------|-----------------------------------|---------------|-------------------|------------|
| 1 | Account Identifier | Financing Amount | Projected Total Monthly Payments | Actual Avg Total Monthly Payments | Estimated APR | Retrospective APR | APR Spread |
| 2 | 123456 | 20,000 | 2,000 | 2,400 | 35% | 42% | 18% |
| 3 | 123457 | 25,000 | 3,000 | 2,550 | 33% | 28% | -14% |
| 4 | 123458 | 15,000 | 1,000 | 1,050 | 39% | 41% | 5% |
| 5 | 123459 | 40,000 | 5,000 | 4,750 | 24% | 23% | -5% |
| 6 | 123460 | 23,000 | 1,750 | 2,188 | 21% | 26% | 23% |
| 7 | 123461 | 30,000 | 3,000 | 4,500 | 35% | 51% | 45% |
| 8 | 123462 | 30,000 | 2,800 | 1,400 | 18% | 9% | -48% |
| 9 | 123463 | 30,000 | 2,500 | 3,500 | 40% | 55% | 37% |
| 10 | 123464 | 30,000 | 5,000 | 10,000 | 46% | 83% | 79% |
| 11 | 123465 | 8,000 | 3,000 | 900 | 31% | 11% | -63% |
| 12 | 123466 | 8,000 | 600 | 618 | 36% | 37% | 3% |
| 13 | 123467 | 40,000 | 5,000 | 22,500 | 4% | 13% | 226% |
| 14 | 123468 | 40,000 | 25,000 | 26,000 | 400% | 412% | 3% |
| 15 | | | | | | | |
| 16 | Audited APR Spread | | | | | | 5% |

Discussion of Economic Impacts

A rulemaking clarifying the applicability of CCFPL § 90009(e) to small business recipients would bring substantial economic benefits to California business owners, just when entrepreneurs are most in need of financial relief due to COVID-19. The RBLC estimates that the 400,000 small businesses applying with online lenders are currently overpaying for credit by \$665 million to \$5.4 billion dollars annually, due to the lack of enforced transparency requirements for financing providers. Robust enforcement of SB 1235 through a UDAAP rulemaking would enable small businesses to comparison shop and select lower-cost credit products when possible. We estimate that the ability to opt into lower-cost financing as a result of increased transparency will enable 127,000 of the nearly half a million California businesses applying to online lenders to save billions of dollars annually in direct and indirect savings. Business owners will have the ability to save on direct credit costs, as well as the secondary consequences of high-cost debt: opportunity costs of time spent seeking to refinance unsustainable debt, the trickle-down costs of credit score reductions caused by loan defaults, and lost future revenue resulting from debt-related bankruptcies.

Direct Savings: Access to Lower-Cost Credit

Using data from the Federal Reserve, we estimate that universal transparency standards may enable 127,000 California small businesses to select a more affordable financing option than they would have selected without access to easily understandable disclosures. We estimate that these businesses could save \$617 million to \$2.9 billion annually when empowered with the transparency needed to compare products and make informed credit decisions.³⁶ Moreover, we expect business owners of color, who apply for

³⁶ Responsible Business Lending Coalition, “Re: Third Invitation for Comments on Proposed Rulemaking Commercial Financing Disclosures, File No: 01-18,” January 31, 2020. See pages 2-3.
http://www.borrowersbillofrights.org/uploads/1/0/0/4/100447618/rbcl_comment_-_commercial_financing_disclosures_pro_01-18.pdf

online financing at higher rates according to the Federal Reserve, to disproportionately benefit from expected savings.

Secondary Effects: Avoiding Trickle-Down Consequences of Unaffordable Financing

Universal disclosure standards would also enable business owners to achieve significant savings by preventing the secondary consequences of high-cost credit. . For example, by understanding the cost of credit upfront, business owners could avoid opportunity costs of their time spent applying to refinance debt that later proved to be unaffordable and unsustainable. Responsible lenders in our coalition frequently encounter businesses seeking to refinance out of debt from higher-cost financing providers, with terms that were not clearly disclosed upfront. According to the Federal Reserve Bank of New York, businesses spend a whopping 26 hours applying for financing on average.³⁷ We multiplied this time by the average hourly wage for business owners and by the number of businesses expected to opt for lower cost financing when given clear disclosures, to identify opportunity cost savings in the tens of millions of dollars.³⁸

Small businesses may also indirectly save by avoiding credit score damage that could result from defaults on unaffordable credit products. One estimate suggests that individuals who experience a credit score decline from fair to poor may spend an additional \$150,000 on commonly-used credit products (e.g. mortgages, auto loans, and credit scores) over their lifetimes.³⁹ If we assume that ten percent of the small business borrowers who are price sensitive and apply to online lenders would have defaulted on their financing as a result of UDAAP concerns such as the practices described above, affected businesses could save several billion dollars in future credit costs by preserving their credit scores.

In addition, small business owners could achieve substantial indirect savings by avoiding business closures as a result of unaffordable financing. We estimated these savings by assuming that ten percent of price-sensitive online loan applicants could have risked closure by taking on a high-cost credit product. Of that ten percent, we assume fifty percent would have otherwise remained in business for the average small business life cycle of 7.5 years, if not for the unaffordable credit product forcing the business into bankruptcy.⁴⁰ Average annual revenues for employer firms with under 20 employees and nonemployer firms range from \$47,000 to over \$1.6 million.⁴¹ In multiplying the estimated number of at-risk firms by average revenues, we estimate that business owners may save as much as ten billion dollars annually by avoiding debt traps with access to clear, comparable disclosures.

Table: Direct and Secondary Effects of Robust SB 1235 Enforcement Through UDAAP

| Economic Benefit | Description | Annual Savings |
|-------------------------|---|--------------------------------|
| Switching savings | An estimated 127,000 California businesses may select lower-cost financing as a result of transparent | \$617 million to \$2.9 billion |

³⁷ Federal Reserve Bank of New York, “Key Findings: Small Business Credit Survey, Q4 2013,” 2013. <https://www.newyorkfed.org/medialibrary/interactives/fall2013/fall2013/files/full-report.pdf>

³⁸ ZipRecruiter, “Business Owner Salary,” March 9, 2021. <https://www.ziprecruiter.com/Salaries/Business-Owner-Salary>

³⁹ Holland Sentinel, “You Could Pay \$279,000 of Interest Over Your Lifetime,” November 13, 2019. <https://www.hollandsentinel.com/article/20141114/BUSINESS/311149988>

⁴⁰ Nav, “Small Business Statistics,” January 26, 2021. <https://www.nav.com/small-business-statistics/>

⁴¹ Fundera, “Small Business Revenue Statistics (2021): Annual Sales and Earnings,” December 16, 2020. <https://www.fundera.com/resources/small-business-revenue-statistics>

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| | disclosures, enabling them to save on finance charges and fees. | |
| Avoided opportunity costs: time spent refinancing high-cost debt | Up to 127,000 price-sensitive loan applicants may need to refinance out of costly debt after struggling to keep up with higher-than-anticipated repayment schedules that were not clearly disclosed upfront. These business owners then must take time away from running their businesses to apply with new credit providers, complete paperwork, submit supporting documentation, etc. | Tens of millions of dollars annually |
| Avoided credit score reductions: increased costs of future credit products acquired | An estimated 13,000 California businesses may experience avoidable defaults on high-cost credit products annually. Missed payments and/or collections are typically reported to credit bureaus and lower the individual's credit score. Thus, credit reductions increase the cost of future credit products acquired by the business owner. | Billions of dollars annually |
| Preservation of future revenue by avoiding premature, debt-induced business closures | An estimated 6,000 California businesses may be forced to close their doors unexpectedly as a result of unsustainable debt draining their cash flow. If not for the high-cost debt, these businesses may have survived and earned revenue over the average small business life cycle of 7.5 years. | Up to ten billion dollars annually |

Thank you for your critical work to protect Californians while fostering innovation in the financial markets that serve us. If we can be of any service, please do not hesitate to contact us at info@borrowersbillofrights.org.

Sincerely,

1. The Responsible Business Lending Coalition

Members include Accion Opportunity Fund, Community Investment Management, Funding Circle, Lending Club, Opportunity Finance Network, Small Business Majority, and the Aspen Institute

2. Access Plus Capital
3. Accion Opportunity Fund
4. Agriculture & Land Based Training Association (ALBA)
5. AmPac Business Capital
6. American Fintech Council

Executive Committee members include Affirm, Avant, Cross River, LendingClub, Marlette Funding, Prosper, SoFi, Upstart, and Varo

7. AnewAmerica Community Corporation
8. Asian Pacific Islander Small Business Program
9. Bankers Small Business CDC of California
10. Bay Area Development Company
11. California Asset Building Coalition
12. The California Association for Micro Enterprise Opportunity (CAMEO)
13. California Capital Financial Development Corporation
14. California Hispanic Chamber of Commerce
15. California Small Business Development Center (SBDC) - Valley Community
16. CDC Small Business Finance
17. The COOK Alliance
18. Consumer Federation of California
19. The CraneWorks
20. Economic Development & Financing Corporation
21. El Pajaro Community Development Corporation
22. Fondo Adelante, Mission Economic Development Agency
23. Fresno Area Hispanic Foundation
24. Funding Circle
25. Halo Business Finance Corp
26. The Greenlining Institute
27. Inclusive Action for the City
28. Inner City Advisors
29. Invest in Women Initiative
30. International Rescue Committee's Center for Economic Opportunity
31. Jefferson Economic Development Institute (JEDI)
32. LendingClub
33. Lighter Capital
34. Main Street Launch
35. Marian Doub Consulting
36. Maximum Reach 4 Economic Equity
37. Multifunding

38. Prospera Community Development
39. Public Law Center
40. Renaissance Entrepreneurship Center
41. San Francisco African American Chamber of Commerce (SFAACC)
42. Silver Lining
43. Small Business California
44. Small Business Majority
45. Wadeco Business Center
46. Women's Economic Ventures
47. Working Solutions

Appendix: Memorandum to DFPI from Richard Cordray and Ed Howard on behalf of the Office of Kat Taylor, Regarding the Enforceability of Regulations Protecting Small Businesses Promulgated Pursuant to Financial Code Section 90009(e).