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**UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA**

SMALL BUSINESS FINANCE
ASSOCIATION,

Plaintiff,

vs.

CLOTHILDE HEWLETT, solely in her
official capacity as Commissioner of the
California Department of Financial
Protection and Innovation,

Defendant.

Case No.: 2:22-cv-08775-RGK-SK

**[PROPOSED] MEMORANDUM OF
POINTS AND AUTHORITIES OF
PUBLIC COUNSEL, UC BERKELEY
CENTER FOR CONSUMER LAW &
ECONOMIC JUSTICE, CALIFORNIA
ASSOCIATION FOR
MICROENTERPRISE OPPORTUNITY,
THE RESPONSIBLE BUSINESS
LENDING COALITION, AND THE
OFFICE OF KAT TAYLOR AS AMICI
CURIAE IN SUPPORT OF
DEFENDANT’S MOTION FOR
SUMMARY JUDGMENT**

Date: October 30, 2023
Time: 9:00 AM
Courtroom: 850
Judge: Hon. R. Gary Klausner
Complaint filed: December 2, 2022
Disc. Cut-Off: September 13, 2023
Mtn. Cut-Off: September 27, 2023
Trial Date: December 12, 2023

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1 **INTERESTS OF AMICI CURIAE**

2 Proposed amici curiae Public Counsel, U.C. Berkeley Center for Consumer Law
3 & Economic Justice, California Association for Microenterprise Opportunity, the
4 Responsible Business Lending Coalition, and the Office of Kat Taylor are a group of
5 organizations with expertise in small business lending and a strong interest in
6 preserving price transparency in that market. Individual statements of interest are in
7 proposed amici’s motion for leave.
8

9 **INTRODUCTION AND SUMMARY OF ARGUMENT**

10 The regulations promulgated by the Department of Financial Protection and
11 Innovation (DFPI), Cal. Code Regs. tit. 10, § 901 *et seq.* (the “Regulations”) responded
12 to a clear need identified by the California Legislature to address predatory practices in
13 the small business lending market and help small businesses better understand sales-
14 based financing (SBF) products. Pursuant to the Legislature’s detailed statutory
15 provisions requiring transparent pricing standards, the DFPI mandated estimated
16 annualized percentage rate (APR) as well as other cost disclosures that SBF providers
17 often already make public to their own borrowers and investors. Accordingly, they
18 satisfy the First Amendment’s compelled speech standards because they were
19 reasonably and carefully designed to forestall deception of small businesses. *See Am.*
20 *Beverage Ass’n v. City & Cty. of S.F.*, 916 F.3d 749, 756 (9th Cir. 2019) (en banc).
21 Specifically, the Regulations obligate “purely factual and uncontroversial” information
22 already disclosed by SBF providers like those that Plaintiff Small Business Finance
23 Association (SBFA) represents and are thus not “unduly burdensome.” *Cal. Chamber of*
24 *Comm. v. Council for Educ. & Rsch. on Toxics*, 29 F.4th 468, 477 (9th Cir. 2022); *see*
25 *Zauderer v. Office of Disciplinary Counsel*, 471 U.S. 626 (1985).
26
27
28

ARGUMENT

I. THE DFPI’S REGULATIONS ADDRESS CONFUSION AND OPACITY IN THE SALES-BASED LENDING MARKET.

The Regulations require clear disclosures of basic terms for all types of small business financing, including SBF products, in accordance with the Legislature’s goal to rein-in an industry that has long preyed on California’s small businesses and entrepreneurs. SBF products such as merchant cash advances (“MCA”) advance funds to small businesses in exchange for a share of future sales.¹ However, the unregulated SBF industry has historically relied on “aggressive, and often misleading” tactics to ensnare small business borrowers in financing schemes with obscure and abusive financing terms that often conceal high prices of those products.²

Federal regulators have observed that commercial loan products like MCAs often charge extraordinarily high estimated APR rates; sometimes “in the triple digits.”³ Yet, because these financing products are not ordinary loans that charge interest but, rather, obligate the borrower repay their cash advance plus a “factor” percentage of their

¹ See Def’s Req. for Judicial Notice (“RJN”) Ex. B at 4 (defining MCAs in SB 1235’s legislative history) (ECF No. 12-2); *see also, e.g.,* Alexander J. Callen, Danielle Reyes, & Juliana Gerrick, *CFPB Deems Merchant Cash Advances to Be “Credit” Under ECOA*, Goodwin Law (April 27, 2023) <https://perma.cc/5CTQ-SZRA>; DFPI, *Advisory to Small Businesses with Merchant Cash Advance Contracts*, <https://perma.cc/W6PD-ZRGC>; Randa Kriss & Steve Nicastro, *Is a Merchant Cash Advance Right for Your Business?*, Nerd Wallet (Sept. 7, 2023), <https://perma.cc/5EP5-ARGE>.

² Evan Zullo, Sandhya Brown, & Malini Mithal, FTC, *Strictly Business Forum Staff Perspective* 6 (Feb. 2020), <https://perma.cc/2WMU-DRXE/>; *see also* Joyce Klein, *We protect individuals from predatory lending practices — why not small businesses too?* Aspen Inst. (Feb. 17, 2022), <https://perma.cc/3XA6-D5MW>.

³ Zullo, Brown, & Mithal, *supra* note 2, at 6; Barbara J. Lipman & Ann Marie Wiersch, *Alternative Lending Through the Eyes of “Mom-and-Pop” Small-Business Owners*, Fed. Rsrv. Bank of Clev., 4 (Aug. 25, 2015), <https://perma.cc/F6EW-HFKB> (cautioning that “these credit products are unsecured and often carry effective interest rates that exceed those of traditional bank products”).

1 revenues,⁴ SBF providers have managed to skirt traditional financing laws.⁵
 2 Significantly, providers have long confused customers in the same way they now
 3 attempt to confuse this Court.⁶ Providers regularly use arcane semantic distinctions and
 4 unfamiliar terminology to sell what Federal Reserve researchers have described as
 5 “potentially higher-cost and less-transparent credit products.”⁷ For example, SBFA
 6 claims that small business owners do not “owe” the financing amount if their business’s
 7 sales fall as in a traditional loan, Compl. ¶ 28, but providers’ sharp practices in
 8 collecting every penny even if the business’s sales fall have been the subject of
 9 significant scrutiny, including in a series of articles by *Bloomberg News*.⁸ Ultimately,
 10 any distinctions between MCAs and loans matter little to potential borrowers. The
 11 Regulations are accordingly designed to help small business owners compare the prices,
 12 regardless of how money advanced is repaid.
 13
 14

15 For small businesses, the results of unregulated SBF products are often
 16 devastating. One analysis of their contracts found that the average undisclosed APR
 17 charged was 94 percent, and that some APRs exceeded 350 percent.⁹ Moreover, the
 18

19 ⁴ Zullo, Brown, & Mithal, *supra* note 2, at 6.

20 ⁵ Whether SBF products are loans and thus subject to lending laws is heavily litigated;
 21 however, some courts have suggested that they are loans and thus subject to state usury
 22 laws. *See, e.g., Essex Partners Ltd. v. Merch. Cash & Cap.*, 2011 WL 13123326, at *6-
 23 7 (C.D. Cal. Aug. 1, 2011).

24 ⁶ For instance, SBFA’s description to this Court of its mission, Compl. ¶ 4,
 25 disingenuously changes the word “lending” to “financing” in the phrase “small
 26 business *lending* market,” which is how it describes itself on its website. *Small Business
 27 Finance Association*, <https://perma.cc/54T7-555C>; *see* Def.’s Mot. for Summ. J.
 28 (“MSJ”) at 13-14 (ECF No. 52).

⁷ Mels de Zeeuw, *Small Business Credit Survey Report on Minority-Owned Firms*, Fed.
 Rsrv. Bank of Atl. at p. IV (Dec. 2019), <https://perma.cc/XA9B-WRAG>.

⁸ *Sign Here to Lose Everything: The Predatory Lending Machine Crushing Small
 Businesses Across America*, Bloomberg, <https://tinyurl.com/wpjhpv4>.

⁹ Eric Weaver et al., *Unaffordable and Unsustainable: The New Business Lending on*

1 average payment was 178 percent of the business’s net income. In other words, the
2 *average* payment was about *double* what the small business could afford, pushing them
3 into unprofitability and, sometimes, even bankruptcy.

4
5 SBF providers, moreover, mislead their customers by concealing their known
6 APR rates, and, therefore, make it nearly impossible for small businesses to compare
7 the prices of the products with other options—something that they have regularly asked
8 for. The Federal Reserve has repeatedly documented that small businesses are, at best,
9 confused by how SBF compares to traditional financing and, at worst, lured into buying
10 ruinously expensive SBF products.¹⁰ The lack of clear disclosures, especially the
11 absence of an estimated APR, can mislead customers into accepting higher-priced
12 financing. For example, three different providers’ publicly advertised products with a
13 1.15 factor rate, 4 percent fee, and 9 percent simple interest rate had hidden estimated
14 APR equivalents of about 70 percent, 45 percent, and 46 percent.¹¹ Another study found
15 that 700 personal and business bankruptcies in the past 10 years have been associated
16 with large SBF providers.¹² In one case, a popular Oakland restaurant had to file for
17
18

19 _____
20 *Main Street*, Opportunity Fund, 3 (May 2016) <https://perma.cc/X9G4-DHFD>.

21 ¹⁰ See, e.g., Ann Marie Wiersch et al., *Clicking for Credit: Experiences of Online*
22 *Lender Applicants from the Small Business Credit Survey*, Fed. Rsrv. Bank of Clev., 4
23 (Aug. 2022), <https://perma.cc/WYT2-6L7C>; Barbara J. Lipman & Ann Marie Wiersch,
24 *Uncertain Terms: What Small Business Borrowers Find When Browsing Online Lender*
25 *Websites*, Bd. of Governors of the Fed. Rsrv. Sys. (Dec. 2019) (hereafter *Uncertain*
26 *Terms*), <https://perma.cc/37Q6-J3F5>; Barbara J. Lipman et al., *Searching for Small*
27 *Business Credit Online: What Prospective Borrowers Encounter on Fintech Lender*
28 *Websites*, Consumer & Cmty. Context 3, 7 (2019), <https://perma.cc/W938-C8EK>;
Lipman & Wiersch, *Alternative Lending Through the Eyes of “Mom-and-Pop” Small-*
Business Owners, *supra* note 3, at 5-6.

¹¹ Lipman & Wiersch, *Uncertain Terms*, *supra* note 9, at 18.

¹² Ben Wieder, *Their Bakery Faced a Cash Crisis. The Solution Nearly Cost Them The*
Business, The Sacramento Bee, July 2, 2023. **Attached as Exhibit A.**

1 bankruptcy after its owner could not repay an \$85,000 merchant receivables purchase
2 agreement that the owner had mistakenly believed was a loan.¹³ And as a San Francisco
3 fitness studio owner describes his experience using an MCA: “They do everything in
4 their power to make sure that you can’t compare A to B.”¹⁴ In light of these concerns,
5 small business owners have requested “clearly stated product features and costs to make
6 it easier to compare product offerings,” including expressing interests rates like APR.¹⁵
7 In the Federal Reserve study mentioned above, small business owners reported that
8 “APR was among [the] most helpful details” in different disclosures presented to
9 them.¹⁶ *See also* Def.’s MSJ at 16.

10
11
12 California heard these concerns and acted. In 2018, the Legislature sought to
13 make it easier for small businesses to compare the prices of commercial financing
14 products by passing SB 1235, which mandated more transparency.¹⁷ *See* RJN Ex. B at 4
15 (quoting statement by the bill’s author that “Surveys show that many business owners
16 do not understand the interest rates, prepayment rules and other terms of the financing
17 that is available today and support more disclosure”).¹⁸ The DFPI, following the
18 legislature’s clear instructions—including how commercial financiers must disclose
19 their annualized rate, *see* Cal. Fin. Code § 22804—thereafter issued the Regulations in
20

21
22 ¹³ Paolo Bicchieri, *This Popular Oakland-Based Vegan Restaurant Has Filed for*
Bankruptcy Protection, Eater S.F. (Mar. 21, 2022) <https://perma.cc/ZGY4-V89M>.

23 ¹⁴ Ben Weider, *Even finance whizzes say it’s impossible to compare online small*
business loan options, The Sacramento Bee, June 19, 2023. **Attached as Exhibit B.**

24 ¹⁵ Lipman & Wiersch, *Alternative Lending Through the Eyes of “Mom-and-Pop”*
Small-Business Owners, *supra* note 3, at 7.

25 ¹⁶ Lipman & Wiersch, *Uncertain Terms*, *supra* note 10, at 26

26 ¹⁷ S.B. 1235, 2017-2018 Sess. (Cal. 2018) (codified at Cal. Fin. Code §§ 22800-22805).

27 ¹⁸ The Legislature also recently unanimously passed SB 33, which removes the sunset
28 date from SB 1235, emphasizing the state’s strong interest in regulating the industry.
S.B. 33, 2023-2024 Sess. (Cal. 2023) (codified at Cal. Fin. Code § 22806).

1 response to a legitimate government interest identified by the Legislature.¹⁹

2 **II. SBF PROVIDERS KNOW HOW TO RELIABLY CALCULATE THE**
3 **VARIOUS ESTIMATES REQUIRED BY THE REGULATIONS**

4 SBF providers already possess and regularly disseminate the information—i.e.,
5 Estimated Term and Estimated Payment, as those terms are characterized in the
6 Regulations—that is used to calculate the Estimated APR, which allow small businesses
7 to compare the price of the product. Because this data is based on numbers supplied by
8 the provider itself, it constitutes purely factual and uncontroversial information. *See*
9 *CTIA*, 928 F.3d at 842 (allowing “truthful disclosures in commercial speech” under
10 *Zauderer* in those circumstances). The Regulations simply require a factually accurate
11 statement of the Estimated APR, using the “best information reasonably available” at
12 the time of the disclosure. *See, e.g.*, Cal. Code Regs., tit. 10, § 931(a)(3), (a)(7)(A). The
13 opposition of high-price lenders to disclosing their high prices does not make these
14 disclosures “controversial,” as the information at issue—an Estimated APR, which is
15 calculated with a mathematical formula—does not involve “robust disagreement,” *see*
16 *Cal. Chamber*, 29 F.4th at 478, nor does it require SBF providers to “take sides in a
17 heated political controversy,” *see CTIA*, 928 F.3d at 848. Indeed, it is disingenuous to
18 argue that any calculations based on numbers that the providers themselves maintain or
19 use internally are false or misleading. *See* Def.’s MSJ at 10-11.

23 ¹⁹ SBFA has rightly not argued that the disclosures are not reasonably related to the
24 government’s interest in protecting small businesses from predatory commercial
25 lenders, *see e.g.*, Pl.’s Opp’n to Mot. to Dismiss (ECF No. 19), only that the required
26 disclosures might be non-factual or controversial, discussed below. Indeed, California
27 has a legitimate (indeed, substantial) state interest to protect small businesses against
28 predatory and deceptive practices that conceal high interest rates. *See CTIA—The
Wireless Ass’n v. City of Berkeley*, 928 F.3d 832, 842-43 (permitting disclosures that are
“reasonably related to the State’s interest in preventing deception of consumers”
(quoting *Zauderer*, 471 U.S. at 651))

1 Providers already calculate and rely on estimates required by the Regulations. For
2 example, they commonly explain their products to investors and prospective customers
3 by using estimated terms to compare SBF to traditional lending products. Providers
4 cannot credibly claim that disclosures enabling a comparison of their products to
5 traditional loans are inaccurate or misleading *to customers* while simultaneously
6 comparing their own products to traditional loans *to investors*. See e.g., *Nationwide*
7 *Biweekly Admin., Inc. v. Owen*, 873 F.3d 716, 734 (9th Cir. 2017) (a lender “cannot
8 credibly hold out this disclaimer as evidence that it is already providing potential
9 customers with accurate information while also claiming that the required disclosures
10 are misleading”).
11
12

13 Financiers also provide to their investors the information required by the
14 Regulations, such as the Estimated Payment, Estimated Term, and estimated annualized
15 rate they expect to earn from their products. This information is analogous to the
16 Estimated APR the borrowers pay.²⁰ For example, CAN Capital, which is credited with
17 inventing the modern MCA²¹, provided prospective investors with a table comparing
18 their sales-based MCAs and closed-end loans that provided the collateral for the bond.²²
19 The table, attached as **Exhibit C**, essentially compares the Estimated Term lengths of
20 the MCAs to those of the closed-end loans, estimated to two decimal points.²³ This
21

22 ²⁰ SBFA argues that providing an estimate is misleading, Compl. ¶¶ 22-23, but the
23 Regulations require providers to state that it is an estimate and how it is calculated. Cal.
24 Code Regs. tit. 10, § 931(a) (obligating estimates “only” for SBF products).

25 ²¹ Ed McKinley, *CAN Capital: Beyond Hyperbole*, *deBanked* (Dec. 11, 2015),
<https://debanked.com/2015/12/can-capital-beyond-hyperbole/>.

26 ²² Eric Rapp, Chuck Weilandmann & Kathy Tillwitz, *CAN Capital Funding LCC Series*
27 *2014-1: Presale Report 20* (2014), <https://perma.cc/66Q7-HWXU> (emphasis added).

28 ²³ In Exhibit A, CAN Capital refers to Estimated Term as “Estimated Underwritten
Turn” for MCAs showing that the “estimate” was determined when the MCA was
“underwritten.”

1 information shows that the SBF providers compare their loan and SBF products on an
2 “apples to apples” basis using informed estimates when communicating to investors.
3 The same document stated that CAN’s collateral pool of MCAs had an “expected
4 weighted-average annual return [i.e., an Estimated APR] . . . of approximately 48%.”²⁴

5
6 Furthermore, prior to the enactment of the Regulations, numerous websites
7 selling leads to SBF companies offered a variety of free, online calculators to help small
8 business owners compute the APRs of MCAs.²⁵ The existence of those online
9 calculators demonstrates the demand from small businesses—and market recognition of
10 the demand—for help deciphering the Estimated APRs of SBF products, as well as the
11 standard practice in the industry to help small businesses attempt to calculate APRs too.
12 It also shows that compliance with the Regulations would not be unjustified or unduly
13 burdensome for SBF providers, as some already provided those calculations publicly. In
14 fact, SBFA member company RapidFinance now sells software to help providers
15 “efficiently” calculate the figures required by the Regulations.²⁶

16
17
18 **III. THE REGULATIONS REQUIRE ROUTINE INFORMATIONAL DISCLOSURES THAT COMPORT WITH THE FIRST AMENDMENT.**

19 **A. The Regulations Do Not Limit Speech.**

20 As described above, the DFPI’s Regulations mandate factual and
21 noncontroversial statements. They are also not unduly burdensome and therefore meet
22

23
24 ²⁴ Rapp, Weillamann & Tillwitz, *supra* note 22, at 3.

25 ²⁵ See, e.g., *APR Calculator*, American Merchant Brokers (last visited Sept. 26, 2023)
<https://perma.cc/BVJ8-TV5T>.

26 ²⁶ Will Tumulty, CEO of Rapid Finance, described their calculator as giving Industry
27 “the tools they need to help ensure that they can continue to efficiently and compliantly
28 meet the financing needs of their customers.” Businesswire, [Rapid Finance Announces Availability of API Service to Support State-Level Business Lending Disclosure Requirements](https://www.businesswire.com/news/home/20221209005234/en/Rapid-Finance-Announces-Availability-of-API-Service-to-Support-State-Level-Business-Lending-Disclosure-Requirements) (Dec. 9, 2022), <https://tinyurl.com/4suct43f>.

1 the remaining requirements to satisfy the First Amendment under the *Zauderer*
2 standard. *See Cal. Chamber of Comm.*, 29 F.4th at 477.²⁷

3 The required disclosures provide potential borrowers vital information that they
4 need to make informed decisions about Financiers’ products. The difficulty of
5 understanding the cost of SBF products discussed above underscores the critical need
6 for these disclosures and fully justifies the minimal burden that they place on providers.

7 Under *Zauderer*, a required disclosure is “unduly burdensome” only when it
8 “effectively rules out the speech it accompanies,” *Owen*, 873 F.3d at 734, or will “chill
9 [the speaker’s] protected speech.” *Am. Beverage Ass’n*, 916 F.3d at 757. An Estimated
10 APR disclosure poses no such threat to the protected speech of SBF providers. In
11 addition, the Regulations offer borrowers more information, not less, thereby *advancing*
12 the First Amendment’s principles. *See, e.g., id.* (providing consumers with more
13 information in the form of truthful and non-misleading disclosures is a legitimate
14 government interest and aligns with First Amendment principles). Moreover, the
15 disclosures place no limitations on providers’ capacity to provide additional speech
16 explaining any circumstances in which the APR may not accurately express the cost of
17 their products. *See CTIA*, 928 F.3d at 849 (finding required disclosure not unduly
18 burdensome particularly because retailer could supplement it with more speech).

19
20
21
22 **B. The Regulations Also Withstand *Central Hudson* Scrutiny.**

23 Even this Court determines the required disclosures are not “factual and
24 uncontroversial” under *Zauderer*, the inquiry is not over—the Court must then apply the
25 intermediate standard set forth in *Central Hudson*. *See United States v. Philip Morris*
26

27
28 ²⁷ As noted above, SBFA does not dispute that the Regulations are reasonably related to a legitimate government interest.

1 USA Inc., 566 F.3d 1095, 1143 (D.C. Cir. 2009). The Regulations still withstand
2 scrutiny because: (1) the Government has asserted an undisputed substantial interest in
3 protecting borrowers; (2) the regulation directly advances that interest; and (3) and the
4 regulation is not more extensive than necessary to serve the interest. See *Cent. Hudson*
5 *Gas & Elec. Corp. v. Pub. Servs. Comm’n*, 447 U.S. 557, 566 (1980). SB 1235’s
6 legislative history demonstrates that the Regulations directly and materially advance
7 California’s interest in protecting small businesses. See *RJN Exs. A-B*; *Fla. Bar v. Went*
8 *For It, Inc.*, 515 U.S. 618, 626 (1995) (holding this element satisfied by the
9 government’s offering of statistical and anecdotal data). And the Regulations are
10 sufficiently tailored to achieve their objective. The government has to demonstrate only
11 that the disclosure is “proportionate to the interests sought to be advanced.” *Nat’l Cable*
12 *& Telecommc’ns Ass’n v. F.C.C.*, 555 F.3d 996, 1002 (D.C. Cir. 2009). The
13 Regulations go no further than to provide small businesses the information they
14 currently lack when comparing financial products. Accordingly, they fully comport
15 with the requirements of the First Amendment.

16
17
18
19 **CONCLUSION**

20 For the foregoing reasons, the Court should grant DFPI’s Motion for Summary
21 Judgment and deny SBFA’s motion.

22 Dated: September 27, 2023

Respectfully submitted,

PUBLIC COUNSEL

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1 **CERTIFICATE OF COMPLIANCE**

2 Pursuant to Civ. L.R. 11-6.1, the undersigned, counsel of record for proposed
3 amici curiae Public Counsel, U.C. Berkeley Center for Consumer Law & Economic
4 Justice, California Association for Microenterprise Opportunity, the Responsible
5 Business Lending Coalition, and the Office of Kat Taylor certifies that this brief
6 contains 2,115 words, which complies with the word limit of Civ. L.R. 11-6.1, the
7 Standing Order of the Hon. R. Gary Klausner, paragraph 6, and Federal Rule of
8 Appellate Procedure 29(a)(5).
9

10
11 Dated: September 27, 2023

12
13
14 By: /s/ Ghirlandi Guidetti
15 Ghirlandi Guidetti
16 *Attorney for Proposed Amici Curiae*
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First of two stories on unregulated online financing options for small businesses: They're quick and available even to those with imperfect credit ratings. But some say their high costs make them akin to payday loans; bankruptcies tied to these offerings are on the rise. Read the second story [here](#).

WASHINGTON — The good news for Miami entrepreneurs Mariana Cortez and husband Sebastian Ghiragossian was that Whole Foods wanted to sell their popular vegan cupcakes in local stores – a highly-sought measure of success for any small-scale food producer.

TOP VIDEOS

AD



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Then an electrical problem threw a needed expansion of their Bunnie Cakes bakery six months behind schedule and wrecked the project's budget. The couple turned to two online companies that promised them all the cash they needed in a matter of days.

That speed came at a cost. They received \$133,000 and were on the hook for paying back a total of \$193,000 – roughly one-and-a-half times what they had taken out. And the companies providing the funding, Can Capital and Yellowstone Capital, were given direct access to Bunnie Cakes' bank account; they sucked out a portion of the bakery's receipts each day until the full amount was repaid – in a matter of months, not years.

READ NEXT

NATIONAL

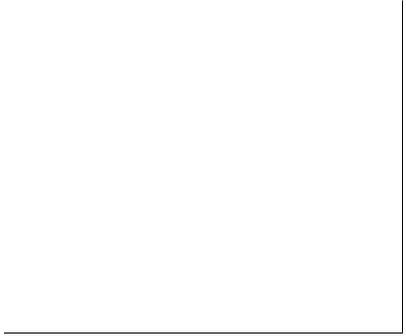
Even finance whizzes say it's impossible to compare online small business loan options

JUNE 08, 2018 5:00 AM

Yellowstone and Can are among the most prominent providers of online loans and so-called merchant cash advances that are increasingly popular with small businesses.

Unfortunately, a growing number of small business owners who have turned to these largely unregulated suppliers of capital have also filed for bankruptcy in the past five years, particularly in Florida.

Call them payday loans for your corner grocer.



“These things have the same functional problems as payday loans, except they’re worse,” said Mike Calhoun, president of the Center for Responsible Lending, a consumer advocacy group. “There’s very manipulative pricing.”

Why sign up for this costly type of financing? For one thing, despite the old bromide that small business is the backbone of the U.S. economy, many of those who run or are trying to start such an effort find it exceedingly difficult to get a traditional bank loan.

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Community and regional banks approved just under 50 percent of their small business loan applications, while the rate was a much lower 25 percent at big banks, [according to an April survey](#) by online lending marketplace Biz2Credit.

Those aren’t great odds, and leave a lot of small businesses – over four hundred thousand of which are started each year, the U.S. Census Bureau estimates – looking elsewhere for financing.

Enter merchant cash advances and other online options.

The contracts typically carry the equivalent of what most would consider a hefty interest rate. The effective annual rate on Bunnie Cakes' biggest contract was roughly 60 percent, an amount that would be considered usurious for similar consumer products in 38 states and Washington D.C., [according to the](#) National Consumer Law Center. And experts say it's not uncommon to see rates for these products that reach into the triple digits.

For Bunnie Cakes, the high costs and daily withdrawals associated with their agreements made it hard to stay afloat.

"That almost put us into bankruptcy," Ghiragossian said. "It was horrible."

[\[Have you taken out any merchant cash advances or online business loans? Tell us about your experience here.\]](#)

SLEEPLESS NIGHTS

Individuals who take out payday loans are getting no bargain. But at least those loans are regulated by the federal Consumer Financial Protection Bureau and most states. Five states and Washington D.C. outright ban them, [according to the](#) National Conference on State Legislatures.

Small business financing attracts far less scrutiny.

"Small business borrowers are not afforded protections that consumer borrowers rely on," said Karen Mills, the former head of the Small Business Administration and a senior fellow at the Harvard Business School.

Merchant cash advance providers, in particular, slip through the regulatory framework, which has led industry observers to label this kind of financing the "Wild, Wild West."

"And many of them do prove to be bad actors," Mills said.

Little attention has been paid at the federal level. But California, where the state Senate passed a bill last week to ensure uniform disclosure of the costs of these less conventional offerings, could be on its way to being the first state in the nation to impose rules on the providers.

The high cost of the quick capital infusions can prove to be a death knell for small businesses already struggling to pay their bills.

"There were nights when we couldn't even sleep," Ghiragossian said. "I remember that and it gives me chills."

Business owners watching payments disappearing from their accounts often wind up in a ditch. A McClatchy analysis found more than 700 personal and business bankruptcies in the past 10 years associated with major merchant cash advance companies, [as identified by](#) industry trade publication deBanked.

And that tally may undercount how many businesses actually have gone under. Because merchant cash advances aren't technically loans, their providers don't necessarily appear as creditors in a bankruptcy filing. And many smaller businesses don't even go through the trouble of filing for bankruptcy if they fail.

"It will just be a sale and the proceeds will be distributed to creditors informally," said Craig Goldblatt, a D.C.-based bankruptcy lawyer at WilmerHale.

The number of bankruptcies has increased each year and there were nearly four times as many in 2017 -- 193 -- as five years earlier.

BANKRUPTCIES ASSOCIATED WITH MERCHANT CASH PROVIDERS

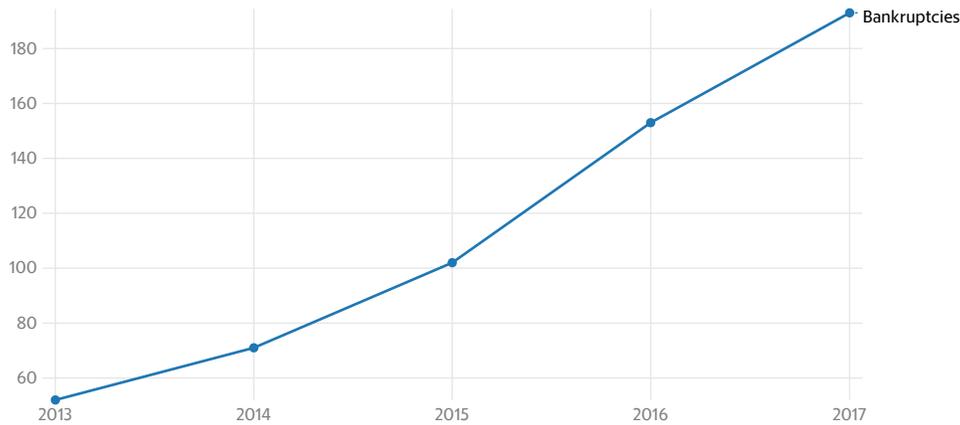


Chart: Ben Wieder • Source: Federal Court Filings • [Get the data](#)

X

One feature that likely contributes to the failures: Merchant cash advance providers and other nonbank lenders don't have to ensure that small business borrowers can afford to repay the funds. That sets these instruments apart from most other types financing, including home mortgages.

Experts say some of the blame rests with the borrowers themselves.

"There are small businesses looking for credit who probably shouldn't be given credit," Mills said.

But when a customer does run aground, these cash providers often are out less than other lenders, because they are repaid directly from the daily receipts of the business, even in its final days.

No state has seen more small businesses fail in connection with this kind of financing, even adjusted for population, than Florida, which accounted for nearly one in five of the bankruptcies reviewed by McClatchy. The Sunshine State saw nearly 40 associated with merchant cash advance companies in 2017 alone.

Miguel Pena's Miami home health care company closed in 2015, but he continued to be pursued by the merchant cash companies and online lenders whose high fees had been part of what drove him out of his business. He was forced to file for bankruptcy both personally and on behalf of the company in 2016.

"It was the worst experience in my life," he said.

CREDIT GAPS

Some entrepreneurs have appreciated the cash these companies provide.

Ainsley and Johnny Tsokos don't regret the cash advances they took out to pay for unexpected costs as they transformed a former beauty salon into Cream Parlor, their ice cream shop and cafe in Miami's Upper Eastside neighborhood.

"The value is that you can make your dreams come true," Johnny Tsokos said. "I would not be here talking to you if we had not had those opportunities."

Industry experts say that the popularity of these products that provide financing in exchange for a percentage of sales -- as well as other nonbank alternatives -- took off around a decade ago, when the recession brought a decline in small business lending from traditional banks.

"Even now, bank lending hasn't fully recovered," said Ann Marie Wiersch, a senior policy analyst at the Federal Reserve Bank of Cleveland.

She co-authored [a 2013 report](#) that pointed to tighter lending standards, decreased borrower demand and long-term consolidation in the banking industry as some of the factors creating a tight market for bank loans to small businesses.

Mills has done research that shows that small businesses have an especially hard time getting traditional loans under \$250,000, which come with many of the same costs for banks as larger loans, but less potential for profit.

"If banks were doing their jobs, companies like us probably wouldn't need to exist," said Jason Fleming, vice president of direct sales at Mulligan Funding, a San Diego-based online funder that mainly offers short-term small business loans.

Some of the slack is taken up by groups known as community development financial institutions, which are banks, credit unions and other groups that offer capital to small businesses owned by minorities or based in economically distressed areas.

After they had paid off their advances, the owners of Cream Parlor turned to one of these groups, a local nonprofit called the Miami Bayside Foundation, for both loans and financial advice.

“They really got in the trenches with us,” Tsokos said. “We are very grateful to these guys.”

But the funding for those nonprofits, which comes in part from grants and tax credits from the U.S. Treasury Department, only goes so far.

“Last year we had 40,000 people reach out for capital,” said Gina Harman, CEO of Accion’s U.S. network of four such lenders. “We can’t make 40,000 loans.”



If you're a small business owner, here are some things to know before you decide to take a merchant cash advance. BY JOSÉ A. IGLESÍAS

X

And the growth of the online cash providers isn’t just a question of need, it also has a lot to do with the fact that they offer a faster, more user-friendly experience. And they provide funding big and small to a wider range of borrowers, including many who have less-than-stellar credit ratings.

“You don’t have to xerox a pile of paperwork and go from bank to bank,” said Mills. “You can now go online and get offers of credit with the touch of button, and you can get the money in your bank account within days or minutes.”

The providers are scattered around the country, though most heavily concentrated in the New York tri-state area and South Florida. One company [was run out of a Long Island office](#) shared with former Trump Organization associate Felix Sater, who had been working on a proposal to develop a Trump Tower in Moscow during the 2016 presidential campaign.

These new offerings still represent a small portion of the overall credit market, but not an insignificant one. In 2016, Treasury estimated that merchant cash advance companies alone offer \$3 billion in credit each year, not counting similar online lenders.

Private equity firms and hedge funds have taken note. New York-based Pearl Capital [was acquired in 2015](#) by Capital Z Partners; Strategic Funding Source, also in New York, got a \$35 million investment in 2014 from Pine Brook Partners; and Maryland-based RapidAdvance was acquired by Rockbridge Growth Equity – co-founded by Quicken Loans founder Dan Gilbert – in 2013. Some of that enthusiasm has dimmed, however, in response to the disappointing performance of online lender On Deck Capital, which is now trading at roughly \$7.00, one-third the amount of its \$20 initial public offering in late 2014.

PUTTING BUSINESSES IN THE GRAVE

A number of factors account for the higher costs associated with merchant cash advances and other online options.

The biggest one: These companies have to pay more than traditional banks to get money to lend out -- often borrowing cash from private equity or hedge funds.

They also tend to take on riskier borrowers than banks, with [lower credit scores](#) and shorter business histories.

But another key driver of costs: Often, there's a middleman.

Brokers can earn commissions of up to 10 or 15 percent on each advance or loan they sell, and are under no obligation to share the best offer available with borrowers.

One trade group that represents a number of merchant cash and online loan providers -- including RapidAdvance, Strategic Funding and BFS Capital -- is currently formulating guidelines on best practices for brokers. ^x

“We want to be able to really help small businesses understand what a good broker is and what a bad broker is,” said Stephen Denis, executive director of the Small Business Finance Association.

Many point to brokers as the culprits behind a practice known as stacking, in which borrowers are encouraged to take on multiple advances or loans.

“It creates a spiraling, vicious cycle of debt,” said Jackson Mueller, associate director of the Milken Institute’s Center for Financial Markets.

The reality, though, is that some merchant cash providers themselves don’t believe it’s their job to help entrepreneurs succeed, said Levi King, CEO of Nav, a web site that collects financial information from small businesses and provides recommendations on the best loans or credit products available to them.

He recalled a conversation with the CEO of one merchant cash company based in New York, in which the CEO compared his company’s small business borrowers to patients with stage 4 cancer.

“Does our product put them in the grave faster?” King remembered the CEO saying. “Yeah, but that’s a service to them.”



When unexpected construction costs threw their budget off, married co-owners Mariana Cortez and Sebastian Ghiragossian turned to a couple of online companies that promised them all the cash they needed in a matter of days. It started a world of hurt. BY EMILY MICHOT

Your Merchant Cash Advance Experience

McClatchy now wants to hear from you. If you have had experience with merchant cash advances or online business loans, please tell us your story. (We will not use any of the information your provide without your explicit permission.)

advocates4consumerjustice@gmail.com [Switch account](#)



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* Indicates required question



Has your small business taken out a merchant cash advance or online business loan? *

Yes

No

Ben Wieder: [202-383-6125](tel:202-383-6125), [@benbwieder](https://twitter.com/benbwieder)

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EXHIBIT B

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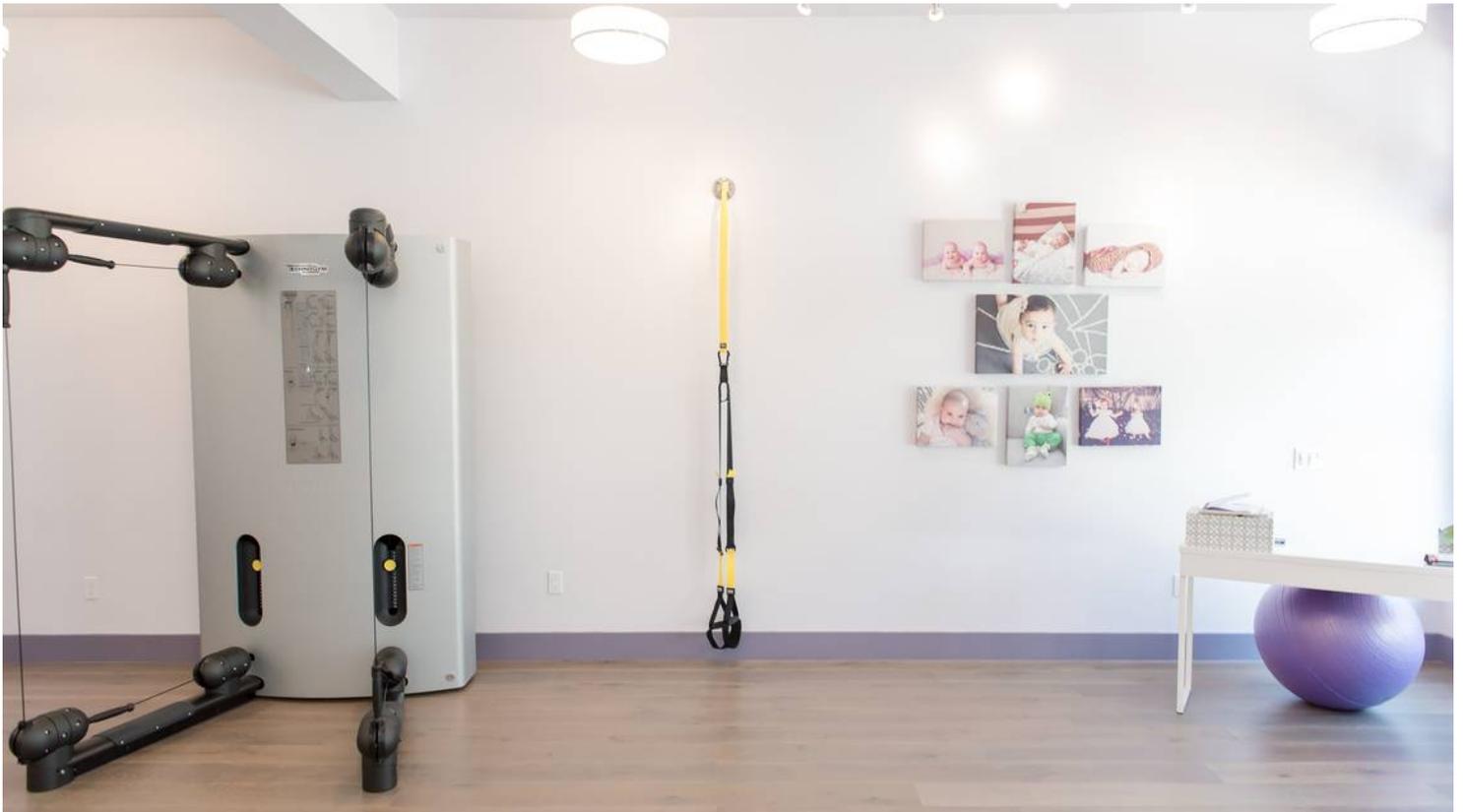
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HOMEPAGE

Even finance whizzes say it's impossible to compare online small business loan options

BY BEN WIEDER

UPDATED JUNE 19, 2023 3:38 PM



The Lotus Method fitness studios in the San Francisco area cater to pregnant women and new moms. *Courtesy of The Lotus Method*



Only have a minute? Listen instead

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Second of two stories on unregulated online financing options for small businesses: They're quick and available even to those with imperfect credit ratings. But some say their high costs make them akin to payday loans, and bankruptcies tied to these offerings are on the rise. Read the first story [here](#).

WASHINGTON — With more than a decade of experience working in finance, Wesley Kennedy is savvier about money than the average small businessperson.

He figured his expertise would land him and his wife funding at favorable terms when they needed quick cash to help them expand The Lotus Method fitness studios they run in the San Francisco area, which cater to pregnant women and new mothers.

TOP VIDEOS

AD



But when he turned to nontraditional, [online companies for the financing](#), he was surprised by what he saw. Unlike banks, these companies require direct access to a business's bank account or credit card payment system. Every day, they drain out a set amount – or sometimes a percentage of sales – until they're paid an agreed-upon sum for having provided the money in the first place.

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NATIONAL

Their bakery faced a cash crisis. The solution nearly cost them the business.

JUNE 07, 2018 5:00 AM

And when he tried to compare offers from different companies, his frustration level hit the ceiling.

“They do everything in their power to make sure that you can’t compare A to B,” he said, with fees, costs and other terms presented in a myriad of ways from company to company.

That would change under [a bill making its way through the California statehouse](#) that would require the online firms offering loans and merchant cash advances (which are similar to online loans but have no fixed repayment terms) to disclose up front the annualized cost of the financing they provide and all the fees attached to their products; those frequently aren't spelled out for business owners.

If it passes, the California measure would be the first in the country to impact this largely unregulated realm of credit that small businesses sometimes are forced to rely on.

“Especially in the market for short-term financing, you see loans and cash advances with high fees and charges that are often not clear to the consumer,” said the bill’s sponsor, Democratic state Sen. Steve Glazer of Orinda, Calif. “That’s why this bill proposes a simple, consistent disclosure for all small business financing in California.”

While many of the companies that would be affected — firms like Yellowstone Capital, Everest Business Funding and Platinum Rapid Funding Group — aren’t household names, the bill also would reach some of the best-known technology companies in the country.

Amazon, PayPal and Square each issued roughly \$1 billion in online loans or cash advances in 2017 to businesses that use their services to process payments or sell products. The sums have been climbing steadily; PayPal [even acquired a Delaware-based](#) online provider of loans and merchant cash advances last year, Swift Financial, to continue growing in this space.

Providers big and small of this type of cash would be subject to the California measure — and for the most part, have worked against the legislation.

The bill has found some support in the online lending industry, though.

One of its biggest boosters is Levi King, the CEO of Nav, a website that collects financial information from small businesses and provides recommendations on the best loans or credit products available to them.

“It’s all about transparency and sales practices and metrics you can compare against,” said King, who started several small businesses himself before entering the online lending industry.

And some alternative lenders and merchant cash providers dropped their opposition to the bill, after Glazer tweaked its annual cost calculation requirement.

“What we’ve tried to do in California is work with the legislature to come up with a bill that will help industry but will also help small business owners better understand the products they’re getting into,” said Stephen Denis, executive director of the Small Business Financial Association, one of the trade groups representing companies in the industry.

[\[Have you taken out any merchant cash advances or online business loans? Tell us about your experience here.\]](#)

STRUGGLING FOR BANK LOANS

What the bill does not do is regulate the cost of such financial offerings.

Consumer advocates see that as a problem, and believe that the California legislation – or any attempt to regulate the industry – should cap how much these alternative lenders can charge, or require them to ensure that businesses can actually afford to repay the money they receive, as banks must do when making loans.

“Something that protects the borrower from getting trapped in debt, because disclosure doesn’t,” said Dory Rand, president of the Woodstock Institute, a consumer advocacy nonprofit for based in Illinois.

Not surprisingly, King, whose company makes money off referrals to online loan firms, said he does not support a cap on costs, despite maintaining that his “vision is to materially decrease the death rate of small businesses in the United States.

“There’s times it makes complete sense to borrow money at 300 percent,” he said.

That’s in part because so many small businesses struggle to get loans from traditional banks.

“In the most robust times for credit about half of small businesses aren’t getting a loan,” said Karen Mills, the former head of the Small Business Administration.

She’s done [research that shows](#) it’s particularly hard for small businesses to obtain bank loans of less than \$250,000.

“The banks are the ones that are to blame for this,” said Kennedy, who was eventually able to negotiate terms he could live with for The Lotus Method’s online loans.

He acknowledges that online providers charge “ridiculous fees.” But “if you remove them from the ecosystem, there are a lot of people who aren’t going to get the capital that they need,” he said.

That includes the owners of Los Angeles bakery Southern Girl Desserts.

Catarah Coleman, co-founder of Southern Girls Desserts in Los Angeles, was in tears the day before her wedding over the money she owed to online loan and merchant cash advance providers.

Catarah Coleman and Shoneji Robison picked a seemingly auspicious time to expand: They found a large corner space in a popular mall in Los Angeles in 2012 — and the next year, saw a rush of new customers when they won the Food Network’s Cupcake Wars.

But they maxed out their credit cards and cashed in their retirement accounts to pay for the construction, and still struggled with payroll each month.

When banks turned down their loan applications, a friend from church suggested they go the online route.

The pair wound up taking out loans and advances one on top of the other. The high costs and fast repayment schedules started to mount.

Coleman found herself panicking about repaying the bills, even at what should have been the happiest of times.

“I’m at my wedding the day before in tears, like, “How am I going to do this?” Coleman said.

AN EARLIER STAB AT CONSTRAINTS

The California bill is not the first attempt to regulate online lenders and merchant cash advance companies.

Illinois lawmakers introduced similar legislation in 2016 that, in addition, would have required companies to determine a borrower’s ability to repay before offering a loan or advance, and to be licensed by the state.

That bill was largely the brainchild of Kurt Summers, the city of Chicago’s treasurer, who said he first became aware of the issues surrounding small business capital after he visited each of Chicago’s 77 neighborhoods early in his term.

“Story after story, we heard lack of disclosure [by] the capital providers,” Summers said.

The bill drew quick and furious opposition from both the nontraditional companies and conventional banks. Summers said he called it “the Illinois lobbyist act of 2016.”

The measure never made it to a floor vote.

The California bill was inspired partly by the Illinois effort, but also by a model framework for voluntary disclosure developed by a trade group for several large nonbank lenders like OnDeck Capital and Kabbage. The model, called the [SMART Box](#), envisions disclosure of all the costs and fees associated with cash advances and loans, as well as the equivalent of an annualized rate of interest and the cost per month.

The model is barely used, though.

And the group’s CEO, Scott Stewart, says its members are against the bill, wary of state-driven regulation.

“We think a patchwork of different regulations is not helpful for small business borrowers,” Stewart said.

PASSING THE BUCK

In the absence of regulation, some of the issues surrounding this type of financing — particularly merchant cash advances — have been litigated in the courts.

Many of the lawsuits have alleged that the advances are really loans by another name and, as such, subject to usury laws.

But the merchant cash companies' argument that they're actually purchasing a slice of future business revenue, so the money they provide is an investment, has won out more often than not, according to McClatchy's review of dozens of cases across the country. That includes a much-watched decision in March by a New York State Supreme Court judge in Manhattan confirming that a merchant cash agreement was not a loan and, thus, not subject to usury laws.

One notable exception: A New York State Supreme Court judge in Westchester County ruled against merchant cash company Pearl Capital in October 2016, finding that the terms of the advance -- and testimony from Pearl Capital -- didn't properly establish the advance as an investment, rather than a loan. And Justice David Everett assailed Pearl's agreement with the borrower for being "illegible, with excessively small print."

In 2011, Can Capital settled with plaintiffs in a class action suit in California for \$23.4 million. Again, the suit alleged that the company's cash advances (under the name AdvanceMe) were really usurious loans.

The online options have received little attention in Congress. After [launching an investigation in 2017](#), Rep. Emmanuel Cleaver, D-Mo., who sits on the House Financial Services Committee, said he wants to ensure that the algorithms used to approve, and set terms for, online loans and advances aren't biased based on race, gender or other factors. He hasn't focused on disclosure or capping the costs of these online offerings.

Mills, the former SBA head, and former Sen. Olympia Snowe, a Republican from Maine who used to chair the Senate Committee on Small Business, are preparing recommendations for Congress on improving small business lending; those will include requiring greater disclosure.

Small business lending is on the radar of some federal regulators.

"When small businesses take on high-cost payday-style loans, they can face financial ruin," newly appointed Federal Trade Commissioner Rohit Chopra told McClatchy in a statement. "The FTC is the only federal agency with the authority to crack down on these high-cost small business loans offered by online outfits."

But the FTC's Republican chairman has shown little interest in this area, and has appointed a lawyer who [represented payday lenders](#) to lead the agency's consumer protection unit.

Most observers expect that any meaningful controls on merchant cash advances and other non-bank small business loans will come first at the state, not federal, level.

“If you actually care about having a functioning marketplace for your small businesses you cannot afford to pass the buck to the federal government,” said Summers, the Chicago treasurer.

In California, companies opposed to Glazer’s bill have hired some of the state’s top lobbyists, including Mercury Public Affairs, Platinum Advisors and California Strategies & Advocacy.

Kate Fisher, a lawyer for an industry group that represents some of the biggest merchant cash advance companies, threatened in a May 9 hearing that members of the Commercial Finance Coalition might stop doing business in California if the bill passes.

That drew a fiery response from Glazer.

“If the worry is that somehow by more honestly disclosing the cost of your capital, small business people are going to run away and not borrow the money...then good riddance, get out of here,” he said. “I don’t want them in California, I don’t want them lending to our good people.”

On May 31, the bill received the minimum number of votes it needed to pass the Senate and will be considered this summer by the Assembly.

In Los Angeles, Southern Girls Desserts founder Catarah Coleman said the legislation is needed – and doesn’t believe it would kill the industry.

Lousy disclosure, she said, can lead owners of small businesses to make costly mistakes when they need capital — mistakes that can kill their bakeries, fitness studios, stationery stores, restaurants or whatever enterprises they pour their talents into.

“People still bungee jump knowing they could die,” said Coleman. “But they know they could die.”





When unexpected construction costs threw their budget off, married co-owners Mariana Cortez and Sebastian Ghiragossian turned to a couple of online companies that promised them all the cash they needed in a matter of days. It started a world of hurt. BY EMILY MICHOT

Your Merchant Cash Advance Experience

McClatchy now wants to hear from you. If you have had experience with merchant cash advances or online business loans, please tell us your story. (We will not use any of the information your provide without your explicit permission.)

advocates4consumerjustice@gmail.com [Switch account](#)



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* Indicates required question

Has your small business taken out a merchant cash advance or online business loan? *

Yes

No

Ben Wieder: [202-383-6125](tel:202-383-6125), [@benbwieder](https://twitter.com/benbwieder)

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EXHIBIT C

Collateral Description

The 2014-1 transaction pool characteristics are as of the August 31, 2014, statistical cut-off date. The receivables securitized in this transaction will be a pool of small business loans and MCAs. Summary statistics of the current portfolio data are presented below.

	Loans	MCAs	Total Portfolio
Number of Assets	4,270	2,801	7,071
Aggregate Unamortized Funded Amount	\$ 131,963,318.32	\$ 68,055,438.49	\$ 200,018,756.81
Average Unamortized Funded Amount	\$ 30,904.76	\$ 24,296.84	\$ 28,287.20
Average Funding Size	\$ 45,793.43	\$ 40,462.16	\$ 43,681.58
Weighted Average Term or Estimated Underwritten Turn	13.88	13.53	13.76
Weighted Average Remaining Term or Turn	9.65	9.35	9.55
Average Number of Contracts in Lifecycle	2.80	3.10	2.90
Average Number of Months in Lifecycle	31.16	32.90	31.75
Weighted Average Repayment Amount or Specified Amount to Funded Amount Ratio	1.33	1.31	1.32
Weighted Average CAN Capital Risk Score	8.53	9.90	9.00
Average Years in Business	12.12	12.80	12.39
Average Gross Annual Sales	\$ 1,065,096.87	\$ 769,261.40	\$ 947,909.04
Average % Gross Sales Taken	5.73%	8.11%	6.67%