Predatory Small-Business Lending: Market and Regulatory Failures

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Small businesses are the mainstay of the U.S. economy, but they face particular challenges in acquiring financing because of a set of informational problems. It is difficult for lenders to obtain reliable information about small businesses' finances, and even when they can get information, credit modeling is difficult because of small businesses' heterogenous nature.

These informational problems frustrate quick and efficient evaluation and pricing of credit risk. Consequently, despite the large number of lenders in the market, many small businesses, particularly new, very small, or riskier enterprises, struggle to get any financing offers, and when a small-business borrower does get a financing offer, it rarely has an alternative.

Small-business borrowers thus often face a situational monopoly that leaves them vulnerable to supracompetitive pricing and other predatory lending practices. Regulation, however, provides scant protection because business lending is exempt from most federal and state regulation. As a result, small businesses operate in a world in which there is neither market-generated protection from competition nor regulatory protection.

This Article puts a spotlight on the abusive practices that have emerged in small-business lending: misleading price disclosures, supracompetitive pricing, and aggressive collection techniques that deny borrowers due process. The Article proposes a comprehensive small business-lending regulatory regime, modeled on elements of consumer credit regulation, to address these problems.

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Introduction

Small businesses are the mainstay of the US economy, accounting for 44% of GDP.[1] Despite the ubiquity of small businesses in the economy, they face particular challenges in obtaining financing. Small businesses need financing for both operations and expansion, yet they often struggle to get the financing they need. Indeed, difficulties in obtaining financing are a factor in the extraordinarily high failure rates of small businesses. Nearly a quarter of small businesses fail within their first year, and almost half within five years.[2] Failure has many causes, but a business that is unable to obtain adequate financing is of course more likely to fail. Conversely, a business with sufficient financing may be able to weather a downturn; access to financing can bolster a firm's resilience.[3]

Small businesses are harder than consumers for lenders to underwrite because of two types of informational problems. First, reliable credit data about the business is often unavailable: credit reporting on small businesses is spotty; many small businesses lack audited financial statements; small businesses are often young and have only limited credit and performance histories; and small businesses often depend heavily on their owners' own discretionary financial contributions.[4] The lack of reliable data creates an informational asymmetry that can frustrate lending, as lenders lack the information necessary to confidently price risk.[5]

Second, even when data is available to lenders, it is difficult to model small-business credit risk because of the heterogeneity among small

1. Kathryn Kobe & Richard Schwinn, *Small Business GDP 1998–2014*, U.S. SMALL BUS. ADMIN., OFF. OF ADVOC. 4-5 (Dec. 2018) https://advocacy.sba.gov/wp-content/uploads/2018/12/Small-Business-GDP-1998-2014.pdf [https://perma.cc/733T-BH96] (small businesses accounted for 43.5% of GDP in 2014).

2. Although small businesses are often praised as the engines of American economic growth, the more typical story of American small business is churn. About 20% of small businesses disappear within two years and 44% within five years. *See* Bd. of Gov. of the Fed. Reserve Sys., *Availability of Credit to Small Businesses,* FED. RESERVE tbl. 4 (Oct. 2022) https://www.federalreserve.gov/publications/2022-october-availability-of-credit-to-small-businesses.htm [https://perma.cc/D9V8-8L46]. *See also* Amy E. Knaup, *Survival and longevity in the Business Employment Dynamics data*, MONTHLY LAB. REV. 51 (May 2005) (34% failure rate within one year and over 50% within four years). The high creation rate combined with the high failure rate suggests churn from serial entrepreneurism.

3. *Small-Business Owner Race, Liquidity, and Survival*, JP MORGAN CHASE & CO. INST. 31 (July 2020), https://www.jpmorganchase.com/content/dam/jpmc/jpmorgan-chase-and-co/institute/pdf/institute-small-business-owner-race-report.pdf [https://perma.cc/HB2S-2TZF] (finding that "insufficient liquid assets are a key constraint to small business survival" and that "small businesses with more cash are better able to withstand shorter- and longer-term disruptions to revenue or other cash inflows").

4. *See infra* Sections II.C-D.

5. *See generally* George Akerlof, *The Market for 'Lemons': Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970) (modeling market failure resulting from information asymmetry); Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 AM. ECON. REV. 393 (1981) (modeling asymmetric information resulting in credit rationing).

businesses in terms of assets, cashflows, and risks. Standardized credit scoring models such as those that exist for consumers do not exist for small businesses. Whereas it is generally clear if a consumer is a "good" credit risk based on a standardized credit score, a "good" software development business might look very different than a "good" lawn care business or a "good" ice cream shop or a "good" medical transportation company.

These informational problems in small-business lending mean that many small businesses, particularly newer enterprises, very small "microenterprises," and financially marginal companies struggle to obtain financing. Absent robust, reliable, standardized, information, lenders often cannot figure out how to price the credit, so many smaller businesses are unable to obtain offers of financing. Even when small businesses can get financing, it often takes some time because of the bespoke and often manual underwriting process.[6] This contrasts with today's frequently real-time decisioning of consumer credit applications.

These challenges leave small businesses, particularly those in urgent need for immediate funding, vulnerable to predatory lending; that is, lending with deceptive terms, high costs, onerous repayment provisions, or waivers of legal process. High-cost financing may itself contribute to the high failure rates of small businesses. Small businesses' vulnerability to predatory lending is exacerbated by the lack of regulation of small-business lending.[7]

Whereas extensive federal and state regimes exist to regulate consumer credit, there are scant protections for small businesses. The only federal credit regulation that applies to business lending is a prohibition against discrimination on the basis of protected classes, such as race, religion, and sex.[8] Although the general federal prohibition on unfair and deceptive acts and practices in commerce applies, it does not address supracompetitive pricing,[9] and other federal protections, like the requirement of uniform credit cost disclosures,[10] do not apply to business lending.[11]

Likewise, state laws regulating credit terms, such as usury laws, or imposing lender licensing regimes also do not generally apply to business lending.[12] Sometimes this is because of explicit statutory exclusions for business loans. Other times, however, lenders deploy various devices to

6. *See 2024 FDIC Small Business Lending Survey* 27, FDIC (2024), at https://www.fdic.gov/publications/small-business-lending-survey-2024 [https://perma.cc/USQ9-S7TW] (noting longer underwriting times for loans from smaller banks with manual underwriting).

7. *See infra* Part III.

8. 15 U.S.C. § 1691(a) (2018).

9. 15 U.S.C. § 45(a)(1) (2018); *see also* Complaint, FTC v. RDG Advances, LLC, No. 20-cv-4432 (S.D.N.Y. June 10, 2020) (alleging violations of Section 5(a) of the FTC Act based on alleged misrepresentations about small-business financing terms and collection practices).

10. 15 U.S.C. §§ 1631-32 (2018).

11. 15 U.S.C. § 1603(a) (2018); *see also infra* Part II.A.

12. *See infra* Part II.A.

avoid state regulation, such as contractual choice of law provisions, partnerships with banks that are exempt from state regulation, or the use of transactional forms that purport to be sales of future revenue, rather than loans.[13]

The lack of regulation compounds the difficulties small businesses face in getting financing. Robust competition can generate consumer protection benefits, as bad terms and practices are competed out of the market. Despite the presence of many competing small-business lenders, the informational challenges in small-business lending mean that small businesses looking to borrow often do not have multiple competing offers, so there is no market pressure pushing out bad terms and practices.

Instead, small-business borrowers often struggle to obtain a single financing offer. Thus, a 2019 Federal Reserve System survey found that 21% of small businesses that applied for financing were denied, and another 36% did not receive all the financing they sought.[14] Additionally, 16% of firms that did not apply for financing said that they did not do so because they did not believe they would be approved.[15] In these circumstances, borrowers face high search costs. When borrowers do get a financing offer, they understand that they are unlikely to obtain another offer—or at least obtain one any time soon. The likelihood that further searching will be futile means that when a borrower gets an offer it is unlikely to search for other offers. In the absence of search, lenders can charge monopoly prices, irrespective of the number of competitors in the market.[16]

Lenders compete to attract the customer in the first place, but because of the search dynamics, they do not compete on the terms of offers. Not surprisingly, the result is supracompetitive prices, with annual interest rates sometimes approaching 4,000%,[17] and overreaching non-monetary price terms as well. Thus, small businesses operate in a world where there are neither regulatory protections nor strong, market-generated protection from competition.

Further exacerbating the situation are recent shifts in both the institutional nature of small-business lending and the nature of the lending product itself. Traditionally, small-business lending was undertaken

13. See supra notes 208-212 and accompanying text.

14. *2019 Small-Business Credit Survey: Report on Employer Firms,* FED. RES. BANKS 11 (2019), https://www.fedsmallbusiness.org/reports/survey/2019/2019-report-on-employer-firms [https://perma.cc/S54H-P89U] (finding that 43% of all firms applied for financing, of which 9% received no financing and 14% received partial financing).

15. *Id.* (nothing that 57% of all firms did not apply for financing, of which 9% did not because they believed they would be rejected).

16. *See infra* section III.B.2 (describing the "Diamond paradox" model of monopoly pricing resulting from positive search costs and sequential searches).

17. *See, e.g.*, Complaint at ¶ 67, New York v. Richmond Capital Group LLC, No. 451368/2020 (N.Y. Sup. Ct., June 10, 2020) ("The merchant's annual interest rate, including interest that was purportedly "fees," was 3,910 percent.").

primarily by banks,[18] particularly community banks that leveraged their knowledge about local markets to their advantage.[19] These loans were generally made with guaranties from a federal government agency, the U.S. Small Business Administration ("SBA"). The SBA imposes interest rate caps and other substantive term regulations on the loans it guarantees to ensure that the loans are not abusive of the borrower.[20]

Even when SBA regulations do not apply to a particular loan, banks are themselves regulated for safety and soundness, and their regulators are likely to cast a dim eye on exorbitantly priced loans because that can be indicative of a high level of credit risk. Additionally, community banks face reputational constraints as they are local players that seek to cultivate both small businesses and their owners as long-term customers for various credit, deposit, and investment products.[21] Sharp practices with small-business lending undercut the long-term, cross-product relationship strategy.

Although banks still dominate small-business lending, providing $645 billion in small-business loans in 2019,[22] their share of the market has decreased over the past decade, with new institutional players entering the market.[23] In particular, a substantial share of small-business lending is now provided by online, non-bank lenders ("fintechs").[24] Fintech small-business financing is estimated to have grown from $1.4 billion in 2013 to approximately $44 billion in 2019,[25] and has, by all accounts, grown substantially since then.

Additionally, in recent years platform companies that are not part of the traditional lending sector, such as Amazon, DoorDash, MindBody, PayPal, Shopify, Square, and WalMart, have begun to offer financing to

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18. *See* Bd. of Gov. of the Fed. Reserve Sys., *Availability of Credit to Small Businesses*, FED. RESERVE tbl. 8 (Oct. 2022), https://www.federalreserve.gov/publications/2022-october-availability-of-credit-to-small-businesses.htm [https://perma.cc/D9V8-8L46].

19. *See infra* Section I.B.3.a.

20. *See* 13 C.F.R. §§ 120.211-214 (2024).

21. *See 2024 Report on Employer Firms: Findings from the 2023 Small-Business Credit Survey*, FED. RESERVE BANKS 14 (2024), https://www.fedsmallbusiness.org/reports/survey/2024/2024-report-on-employer-firms [https://perma.cc/K9J8-3G9Z] (finding that 69% of small businesses applying for credit with community banks do so because of an existing relationship with the lender).

22. Off. of Advoc., *Small-Business Lending in the United States,* U.S. SMALL BUS. ADMIN. 5 (2019), https://advocacy.sba.gov/wp-content/uploads/2020/09/Report-2019-Small-Business-Lending-Report.pdf [https://perma.cc/P55U-ZC5E]. Data from 2020-2022 on small-business lending is heavily affected by COVID-19 pandemic related loan programs, rendering it an inapposite baseline for comparison.

23. Small-Business Lending Under the Equal Credit Opportunity Act (Regulation B), 88 Fed. Reg. 35154 (May 31, 2023) (codified at 12 C.F.R. pt. 1002).

24. *Id. See also* Leonore Paladino, *Small Business Fintech Lending: The Need for Comprehensive Regulation,* 24 FORDHAM J. CORP. & FIN. L. 77, 78 (2018). Fintechs sometimes work in partnership with banks.

25. Small-Business Lending Under the Equal Credit Opportunity Act (Regulation B), 88 Fed. Reg. 35154 (May 31, 2023) (codified at 12 C.F.R. pt. 1002); Off. of Advoc., *supra* note 22, at 5.

merchants on their platforms, leveraging their visibility into merchants' cash flows and their ability to automatically debit repayments from the merchants' sale revenues.

Fintechs are still only a limited share of the total small-business lending market, but they have carved out a niche serving small-business borrowers with poorer credit or that need quick funds. Borrowers with poor credit are more likely to apply for financing from a fintech lender, while those with good credit are more likely to apply for a loan from a bank.[26] Likewise, borrowers are more likely to apply for a loan from a fintech lender if they are concerned about the chance of being funded, the speed of the funding, cannot post collateral, or have already been denied funding by other lenders.[27] Not surprisingly, borrower satisfaction with fintech lenders is notably lower than with other types of financial institutions, with high interest rates and unfavorable repayment terms being particular sources of dissatisfaction.[28]

Not only has the institutional mix of small-business financing providers changed, but so too have the products involved. A sizeable share of small-business financing is now provided not in the form of a traditional loan, but as a merchant cash advance ("MCA").[29] An MCA is a transaction that is nominally a sale of the small business's future revenue. Frequently, however, an MCA is merely a disguised loan, taking the form of a sale to avoid credit regulations. MCAs are provided solely by fintechs; it is not a product in which banks deal. Although MCAs remain a small part of the overall small-business financing market, their volume of MCAs increased rapidly from an estimated $8.6 billion in 2014 to $19 billion by 2019,[30] meaning that MCAs account for nearly half of all fintech small-business lending.

Fintech lending, and provision of MCAs in particular, is concentrated on newer, smaller, and more financially fragile businesses that banks generally do not serve.[31] Fintechs generally operate outside of the SBA-regulated market, and the SBA has no involvement with MCAs. Business-lending fintechs are not generally subject to any regulatory supervision. Fintechs lack the reputational constraints and incentives for cultivating

26. *See 2024 Report on Employer Firms: Findings from the 2023 Small-business credit Survey*, FED. RESERVE BANKS 13 (2024) https://www.fedsmallbusiness.org/reports/survey/2024/2024-report-on-employer-firms [https://perma.cc/K9J8-3G9Z].

27. *Id.* at 14.

28. *Id.* at 19-20 (25% of fintech borrowers dissatisfied compared with 5% for credit union borrowers and 6% for small bank borrowers).

29. Small-Business Lending Under the Equal Credit Opportunity Act (Regulation B), 88 Fed. Reg. 35154 (May 31, 2023) (codified at 12 C.F.R. pt. 1002).

30. *Id.*

31. Lei Li, *Merchant Cash Advances (MCA): A Double-Edged Sword for Small Businesses*, AMERICANCREDIT (July 18, 2023), https://amcredit.com/blog/merchant-cash-advances-mca-a-double-edged-sword-for-small-businesses [https://perma.cc/Y5ST-3LXD].

future business that exist for community banks because they lack a local, community-based presence and do not offer multiple lines of products and services that they can leverage a relationship to cross-sell. As a result, fintechs, and especially those offering MCAs, are the subprime lenders of the small business world, providing high-cost and often unsustainable credit to financially vulnerable small businesses.[32]

This Article puts a spotlight on abusive small-business lending practices: misleading pricing disclosures, supracompetitive pricing, and aggressive collection techniques that deny borrowers due process. Consumer credit markets have an extensive regulatory regime designed to protect borrowers from such abuses of market power. This Article argues that key elements of the consumer credit regulatory system should be extended to small-business credit that is personally guaranteed by small-business owners: standardized credit cost disclosures, applicability of state usury caps, and limitations on contractual waivers of due process.

Extending these elements of consumer credit regulation to small-business lending that is guaranteed by the small business's owner—at least for smaller loans—is reasonable because these loans are underwritten based on the owner's personal credit characteristics.[33] With most small-business loans, it is ultimately a consumer—the owner-guarantor—who is on the hook for repayment, such that basic consumer credit protections should apply.

The standard justification for exempting business loans from the regulatory regimes applicable to consumer credit is that regulation is unnecessary because businesses are more financially sophisticated and have the wherewithal to protect themselves from overreaching terms. This Article demonstrates that this justification is without merit. Owner-operated small businesses—the overwhelming majority of American

32. *2021 Small-Business Credit Survey: Report on Employer Firms,* FED. RES. BANKS iii (2021) ("Firms with lower credit scores turned to online lenders (35%) and nonbank finance companies (23%) much more often than did their counterparts with higher credit scores (11% and 11%, respectively).").

33. *2017 Small-Business Credit Survey: Report on Employer Firms*, FED. RES. BANKS 5 (2018) (finding that 87% of small-business owners rely on personal credit scores to finance the business); Julia Fonseca & Jialan Wang, How Much Do Small Businesses Rely on Personal Credit? (Nov. 2022) https://files.consumerfinance.gov/f/documents/cfpb_2022-research-conference_session-6_fonseca-wang_paper.pdf [https://perma.cc/AZ8L-QPPU] (manuscript at 4, 22). The notable exception are the financings offered from platforms like Amazon and DoorDash, where the lender has access to the business's sales information and setoff rights against the business's sales revenue. Unlike most small-business financings, the financing offers from these platforms often do not require a personal guaranty from the small business's owner. *See, e.g.*, *Amazon Launches New Merchant Cash Advance Program Provided by Parafin, Doubling Down on Its Support for Small- and Medium-Sized Businesses*, AMAZON (Nov. 1, 2022), https://press.aboutamazon.com/2022/11/amazon-launches-new-merchant-cash-advance-program-provided-by-parafin-doubling-down-on-its-support-for-small-and-medium-sized-businesses [https://perma.cc/R3WK-LT7M]; *DoorDash Capital—Frequently Asked Questions*, DOORDASH, https://help.doordash.com/dashers/s/article/DoorDash-Capital-FAQ?language=en_US [https://perma.cc/D9VG-DWV2].

businesses—have precisely the same financial sophistication as their owner-operator, and even non-owner-operated small businesses are unlikely to have any particular financial sophistication, as financing is not their line of business. Moreover, even if a business is financially sophisticated, that will not protect it against situational monopoly conditions where a lender can act as a price-maker and dictate take-it-or-leave-it terms.

Accordingly, it is appropriate to extend some of the same protections that currently exist for consumers borrowing for personal, family, and household purposes to small-business loans personally guaranteed by the business's owner. The intended use of the loan proceeds does not present any supportable policy basis for distinguishing the regulatory treatment. There is no reason to distinguish in legal treatment between a loan used to buy a printer for a small business run out of its owner's home and a loan used to buy a printer for the personal use of the small-business owner at home, unless the business loan was underwritten solely on the basis of the business's financial characteristics, not those of its consumer owner's.

Despite the ubiquity of small businesses in the U.S. economy, only a small body of scholarship addresses small-business financing. The literature is primarily empirical work by financial economists that focuses on factors affecting the small-business lending by banks.[34] There is but one article on fintech small-business lending in general,[35] and the sole coverage of MCAs outside of practitioner journals is a student note.[36] The literature has all but ignored the regulation of small-business lending.

A quarter century ago, Professor Ronald Mann bemoaned the lack of academic attention to small-business lending,[37] and that situation remains largely unaltered, even as the small-business lending industry has changed, in part along the trendlines identified by Mann, namely a growth of non-bank lending and advances in information technology expanding credit access.[38] Yet it is this very expansion of access to credit that has

34. *See generally, e.g.*, Kristle R. Cortés, Yuliya Demyanyk, Li Lei, Elena Loutskina & Philip E. Strahan, *Stress tests and Small-business lending*, 136 J. FIN. ECON. 260 (2020); Allen N. Berger & Lamont K. Black, *Bank size, lending technologies, and small business finance*, 35 J. BANKING & FIN. 724 (2011); Mitchell A. Peterson & Raghuram G. Rajan, *Does Distance Still Matter? The Information Revolution in Small-business lending*, 57 J. FIN. 2533 (2002); Philip Strahan & James P. Weston, *Small-Business Lending and the Changing Structure of the Banking Industry,* 22 J. BANKING & FIN. 821 (1998); Mitchell A. Peterson & Raghuram G. Rajan, *The Effect of Credit Market Competition on Lending Relationships*, 110 Q. J. ECON. 407 (1995); Allen Berger & Gregory Udell, *Relationship Lending and Lines of Credit in Small Firm Finance*, 68 J. BUS. 351 (1995).

35. Paladino, *supra* note 24.

36. Jordan Stevens, Note, *The Merchant Cash Advance Industry May Have a Few Bad Apples, but that Does Not Mean It Is Time to Empty the Barrel*, 49 TEX. TECH L. REV. 501 (2017).

37. Ronald J. Mann, *The Role of Secured Credit in Small-Business Lending*, 86 GEO. L.J. 1, 4 (1997).

38. *Id.* at 14-15, 30-36.

concomitantly created the atmosphere for predatory lending problems, a development that Mann did not anticipate.

Mann's work investigated the patterns of the use of secured and unsecured credit by small businesses, focusing on the use of collateral to compensate for creditors' informational deficiencies about debtors. More recently, scholar Claudia Lin-Yun Zhang has written about possible solutions to the creditors' informational problem about prospective small-business borrowers.[39] Zhang identified auditing, collateral, and development of long-term relationships as ways of overcoming the informational asymmetry between borrowers and creditors and argued for creditors to have statutory rights to certain information about debtors. These are reforms that would help address the information asymmetry problem, but not the modeling problem.

Beyond this scholarship, Professor Kelly Cline has analyzed and criticized some states' extension of standardized consumer credit cost disclosures to commercial financings on the grounds of the supposed "sophistication and financial acumen" of businesses,[40] a claim with which this Article takes issue. Cline's work focuses solely on disclosure regulations and does not address supracompetitive pricing or abusive collection practices.

Additionally, Professor Lenore Paladino has identified part of institutional shift in small-business lending, namely that from community banks to online-based nonbank finance companies (fintechs), that often operate outside the ambit of regulation.[41] Paladino calls for wholesale application of the consumer credit regulatory regime, including disclosure and on-going supervision by the Consumer Financial Protection Bureau, as well as state licensing, to small business fintech lenders.[42] Her work does not address the causes of supracompetitive pricing in the small-business lending market, however, nor does it consider abusive collection practices.

Finally, Karen Gordon Mills, a former Administrator of the U.S. Small Business Administration, and Brayden McCarthy have written a white paper that bemoans the "spaghetti soup" nature of the current small-business lending regulatory environment, identifies some problems in small-business lending, and proposes a regulatory action plan that includes a federal charter option for non-bank lenders and standard credit cost disclosures for small-business loans.[43] Notably, despite observing the

39. Claudia Lin-Yun Zhang, *How to Solve the Dilemma of Small Business Finance: a Proposal for Creditors' Statutory Information Right*, 13 U.C. DAVIS BUS. L.J. 128, 130 (2012).

40. Kelly W. Cline, *After All This Time: An Analysis of the Recent Trend to Extend Truth-in-Lending-Style Disclosures to Commercial-Financing Transactions*, 45 CAMPBELL L. REV. 195, 221 (2023).

41. Paladino, *supra* note 24.

42. *Id.* at 92-99.

43. Karen Gordon Mills & Brayden McCarthy, *The State of Small-Business Lending: Innovation and Technology and the Implications for Regulation* 4 (Harv. Bus. School working paper No. 17-042, 2016).

problem of high prices in small-business lending, none of the white paper's recommendations address the issue, and indeed its recommendation of a federal charter option would preempt any applicable state usury laws that restrain pricing.[44]

These scholars' work has, collectively, touched on many of the problems that exist in small-business lending, but none has synthesized all of these issues into a comprehensive story of the market and regulatory failures that bedevil small-business lending. Some of the scholarship was written before the rise of contemporary predatory small-business lending, while other work has a more narrowly focused lens. This Article presents a comprehensive picture of market and regulatory failures in the small-business lending market, identifying the informational problems that lie at the root, connecting them to the institutional and product shifts in the market and to the resulting regulatory gaps.

This Article contributes to the literature on financial markets in several ways. First, it presents the only systematic overview of the small-business financing market, something surprisingly lacking in all scholarly literatures.

Second, it presents the fullest exploration of the informational problems impeding small-business lending. Although Mann and Zhang recognized that there are informational problems in small-business lending, they did not deeply probe the nature of these informational problems but instead focused on the use of collateral to address information asymmetry problems. Left unexplored was what financing markets look like when borrowers cannot pledge meaningful collateral, when both the information asymmetry and the modeling problems apply. This Article shows how in some situations, information about the small business's owner becomes a proxy for information about the small business, such that the loan is really underwritten as an (unregulated) consumer loan. It also shows how online platforms such as Amazon, DoorDash, Square, and Walmart leverage their unique insight into the cashflows of businesses on their platforms and their ability to jump ahead of other competing creditors via setoff rights in order to engage in sales-based financing to borrowers that would otherwise struggle to get funding.

Third, this Article is the first treatment to consider why competition fails to provide meaningful market discipline in small-business lending. Because of the informational problems that lenders face, it is difficult and not always cost effective to evaluate financing applicants, particularly newer and smaller enterprises where the cost of underwriting is large relative to the potential size of the loan. Accordingly, the mere presence of multiple small-business lenders is irrelevant to that cohort of small businesses that struggle to obtain any financing offers. Given this

44. *Id.* at 104.

environment, when small businesses do get a financing offer, they know that they are unlikely to readily obtain another competing offer, so they are unlikely to search further and risk losing the offer they have. Because borrowers do not search after obtaining an offer, every lender is able to price as if it were a monopolist with competition failing to protect against overreaching terms.

Finally, this Article explains why the standard justification for the lack of regulation of small-business lending—the supposed financial sophistication of small businesses—is unsupported. Small businesses generally have no greater financial sophistication than their consumer owners. Accordingly, when those owners are personally liable for the business's borrowing, there is no reason they should be denied the same protections they would have if they borrowed themselves and then made an equity contribution to the business.

This Article proceeds as follows. Part I reviews the landscape of American small business and the various sources of small-business financing. Part II considers the unique informational problems that present in small-business financing and the ways in which different types of fintechs address them. Part III turns to the generally scant regulation of small-business financing and the abuses that have arisen in the absence of regulation: misleading price disclosures, supracompetitive prices, and abusive collection practices that deny borrowers due process. Part IV addresses the reason for the current lack of regulation. It shows how the lack of regulation cannot be justified based on small businesses' supposed financial sophistication but is instead best explained by the historical presence of institutional features that substituted for command-and-control regulation. Part V concludes with a proposal for a comprehensive small-business credit regulatory regime to ensure the availability of transparent, fairly priced small-business credit.

I. Small-Business Financing

A. American Small Businesses

There is no single definition of what constitutes a "small" business. The United States Small Business Administration (the SBA), a federal government agency, uses industry-specific definitions of small business to determine eligibility for government programs and contracting preferences.[45] The SBA's definitions vary depending on the business's industry, based on the North American Industry Classification System.[46] For some industry classifications, the definition is based on annual receipts, while for others it is based on the number of employees, and for yet others

45. 13 C.F.R. § 121.101 (2024).
46. *Id.*

it is based on total assets.[47] The particular thresholds of annual receipts, employees, or total assets that the SBA uses vary by industry. Thus, a business that might be a "small business" in one industry based on annual receipts might not be in another.

Notably, the size thresholds used by the SBA are often substantially higher than one might suppose for a "small" business. Colloquially, the term "small business" evokes ma-and-pa corner store operations, like the local coffee shop or liquor store or perhaps the auto body shop or a photographer or dog training business. At the very least, the implication is that the boss at a small business knows all of the employees.

As used in regulation and statistical reporting, however, the term "small business" can include publicly traded firms with a substantial number of employees, revenue, or assets. Employee size thresholds in SBA definitions range from 500 to 1,500, while annual receipts range from $2.25 million to $47 million, and total asset ceilings go up to $850 million.[48] Thus, for the SBA, a property insurance company with 1,500 employees would still be a "small" business despite having more employees than there are students in many public high schools.[49]

Given the relatively high definitional thresholds, it should not be surprising that *almost all businesses* in the United States are "small businesses." In fact, the definitional thresholds are so high, that 99.9% of United States' 33 million businesses are small businesses.[50] Despite the high definitional thresholds, the overwhelming majority—98%—are in fact quite small, with fewer than twenty employees, and most small businesses—82%—have no employees at all beyond their owners.[51]

SBA's high definitional thresholds limit the usefulness of the term "small business," so the lending market has developed its own informal conventions, dividing small businesses into "middle market" firms, "small enterprises," and "microenterprises." Middle market firms have annual revenue of between $20 million and $500 million, while small enterprises have annual revenue of between $1 million and $20 million, and microenterprises have annual revenue of less than $1 million.[52]

47. 13 C.F.R. § 121.201 (2024).

48. *Id.*

49. *Id.*

50. Off. of Advoc., *Frequently Asked Questions About Small Business, 2023*, U.S. SMALL BUS. ADMIN. (Mar. 7, 2023) https://advocacy.sba.gov/2023/03/07/frequently-asked-questions-about-small-business-2023 [https://perma.cc/XE8Q-TQZY].

51. Off. of Advoc., *2023 Small Business Profile*, U.S. SMALL BUS. ADMIN. 2 https://advocacy.sba.gov/wp-content/uploads/2023/11/2023-Small-Business-Economic-Profile-US.pdf [https://perma.cc/AW4L-GW6L] (27.1 million firms with no employees, and 5.5 million firms with 1-19 employees out of a total of 33.3 million firms).

52. Avinash Arun & Helene Page, *The Future of Small-Business Lending,* MOODY'S ANALYTICS RISK PERSPECTIVES (Nov. 2016), https://www.moodysanalytics.com/risk-perspectives-magazine/convergence-risk-finance-accounting-cecl/principles-and-practices/future-of-small-business-lending [https://perma.cc/Z55M-9ECR].

Although many small businesses are incorporated, they are generally closely held, meaning that they are wholly owned by an individual, spouses, or a family. Most small businesses are owner-operated and cannot readily be financially or operationally separated from their owner-operator. This is certainly true for the 27.1 million small businesses with no employees, as there is only an owner-operator involved in the business's operations.[53] But it is also likely the case for many of the 5.5 million firms with between 1 and 19 employees, and even for some firms with more employees.[54]

The importance of an owner-operator to most small businesses is critical to the dynamics of small business finance for two reasons. First, it means that the financial sophistication of a small business is effectively the same as that of its owner, a consumer. Any specialized knowledge and sophistication the firm has most likely relates to the actual industry of the business. Thus, one would expect a florist or a baker to be skilled at flower arranging or baking, respectively, but not necessarily to have any particular expertise about financial matters.

Second, the centrality of the owner-operator to the small business means that the ability of the small business to obtain credit will generally depend in part on the financial characteristics of its owner-operator.[55] Therefore, even if the small business has a separate corporate existence from its owner-operator, for purposes of financing, such separation will be substantially disregarded by the lender. The lender will expect the owner-operator to guarantee the small business's borrowing, and the financing will be underwritten based on the owner-operator's credit characteristics, such as her credit score.

B. Sources of Small-Business Financing

1. Retained Earnings

Small businesses have multiple potential sources of financing: retained earnings, equity, debt, and asset sales. Retained earnings are the simplest form of financing; the business merely reinvests the proceeds of its activities in itself, rather than dividending the funds to its owner(s) or paying the owner a larger salary. For firms with non-owner employees, using retained earnings is the most common method of financing.[56]

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53. Off. of Advoc., *2023 Small Business Profile*, U.S. SMALL BUS. ADMIN. 2 https://advocacy.sba.gov/wp-content/uploads/2023/11/2023-Small-Business-Economic-Profile-US.pdf [https://perma.cc/AW4L-GW6L].

54. *Id.*

55. *See 2017 Small-Business Credit Survey: Report on Employer Firms*, FED. RES. BANKS 5 (2018) (finding that 87% of small-business owners rely on personal credit scores to finance the business).

56. *2020 Small-Business Credit Survey: Report on Employer Firms*, FED. RES. BANKS 6 (2021).

Retained earnings are finite, as they are limited by the business's past performance, so they are not always an adequate source of financing, particularly for a large acquisition. Additionally, financing from retained earnings is only possible once a firm is up and running; retained earnings do not exist to cover start-up expenses, such as acquiring equipment, leases, insurance, and utility service. Those initial expenses must be covered with an initial equity investment from the owner(s). Furthermore, given that the business is typically supporting the owner-operator, the ability to reinvest retained earnings might be limited because those funds are needed to pay the owner-operator's personal expenses. Thus, owner-operated firms without employees—the vast majority of small businesses—are less likely to rely on retained earnings for financing, if only because a firm with employees is more likely to be more established.

2. Equity Financing

Businesses also sometimes finance ongoing operations with equity financing rounds beyond an initial investment from their owner(s).[57] It is important to recognize that in most cases, however, an "equity raise" by a small business does not mean tapping capital markets. Most small businesses are closely held by an owner-operator or family;[58] very few small businesses have publicly listed shares,[59] and those that do those tend to be larger, "middle market" firms. Generally, equity financing for a small business just means that the small business's owner is putting more money into the business, rather than additional shares being sold to new investors.[60]

The closely held nature of most small businesses limits equity raises as a source of financing: the resources of the owner-operator or owner's family are finite and may already be tied down in the small business. Outside investors are, understandably, reluctant to become minority shareholders in a closely held business where they cannot exercise control and generally lack the protections of securities laws.

57. *Id.*

58. *See* Off. of Advoc., *2023 Small Business Profile*, U.S. SMALL BUS. ADMIN. 2 https://advocacy.sba.gov/wp-content/uploads/2023/11/2023-Small-Business-Economic-Profile-US.pdf [https://perma.cc/AW4L-GW6L] (noting 27.1 million firms with no employees and 5.5 million firms with 1-19 employees out of a total of 33.3 million firms).

59. There are only around 4,300 publicly traded firms in the United States out of a total of around 33.3 million firms. *See* Nicole Goodkind, *The Stock Market Is Shrinking and Jamie Dimon Is Worried*, CNN (Apr. 9, 2024), https://www.cnn.com/2024/04/09/investing/premarket-stocks-trading/index.html [https://perma.cc/T26E-UB2F] (describing the number of publicly traded firms); Off. of Advoc., *2023 Small Business Profile*, U.S. SMALL BUS. ADMIN. 2 https://advocacy.sba.gov/wp-content/uploads/2023/11/2023-Small-Business-Economic-Profile-US.pdf [https://perma.cc/AW4L-GW6L] (noting 33.3 million total firms in United States).

60. *See 2024 Small-Business Credit Survey: Report on Employer Firms*, FED. RES. BANKS 21 (2024) (finding that only 2% of firms received an equity investment in the previous year, and of those that did, it was generally from the owner (71%) or friends and family (60%), rather than from angel investors (30%), equity crowdfunding (17%), or venture capital (8%)).

While a closely held small business's equity financing might come from the accumulated savings of an owner-operator, in many cases the funds are simply borrowed by the owner-operator. For example, the owner-operator might borrow on his own personal credit card or home equity line of credit to pay for the business's expenses. It is the business that receives the proceeds of the loan made to its owner, but only the owner is liable for the debt, the loan is underwritten solely based on the owner's personal credit qualities, not the business's.

3. Debt Financing

Debt financing of various forms is also a possibility for small businesses. Sometimes a firm will obtain internal credit—the owner will provide financing in the form of a loan,[61] but such financing is limited by the owner's resources. Some small businesses rely on trade credit—not having to pay for goods or services immediately upon delivery. Yet trade credit provides only a limited and unpredictable amount of float.

Alternatively, the small business might itself obtain a term loan or line of credit from a bank or from a non-bank finance company. Although the business is itself the borrower, small-business loans are frequently underwritten based on the personal credit of the business owner and are often personally guaranteed by the business owner.[62] This is particularly true for smaller enterprises.

a. Community Banks

Historically, community banks were the major source of credit for small businesses, but finance companies, including "fintechs" that operate without a brick-and-mortar presence, play an increasingly important role in small-business lending, particularly for borrowers with poorer credit.[63] Although community banks play only a minor role in consumer lending, they have historically excelled in small-business lending because the heterogeneity of small-business lending markets plays to their strengths.

Community banks have an advantage in small-business lending over megabanks or finance companies that operate on a national scale for two reasons. First, they possess local knowledge about markets, business

61. *Id.* (noting that 33% of firms that sought and received financing in the prior year received non-equity investment funds from the owner).

62. *See, e.g.*, Dock Treece, *Personal Guaranties and Business Loans*, BUS. DAILY NEWS (Aug. 7, 2024), https://www.businessnewsdaily.com/16467-personal-guarantee.html [https://perma.cc/H9TW-3LHU]; *2017 Small-business credit Survey: Report on Employer Firms*, FED. RES. BANKS 5 (2018) (finding that 87% of small-business owners rely on personal credit scores to finance the business, and 55% of borrowings have a personal guaranty).

63. Paladino, *supra* note 24, at 78.

conditions, and locations.[64] And second, their decision-making is generally done by in-person loan committees[65] that are capable of accounting for the unique factors regarding a small business, rather than being driven by mathematical models that cannot accommodate non-conforming data points.[66]

These factors are of limited benefit in the national consumer lending markets that are dominated by megabanks, but they are essential for successful small-business lending. Likewise, although community banks lack the economies of scale that are critical in consumer finance markets, small-business lending does not depend on economies of scale. Accordingly, small-business lending has been a market in which local community banks can better compete against larger, national financial institutions.[67]

Not surprisingly, larger financial institutions are relatively uninvolved in small-business lending.[68] For example, at the end of the third quarter of 2024, banks with less than $10 billion in net assets—a common definition for a "community bank"—held 59% of the total dollar volume of small-business loans secured by nonfarm, nonresidential properties for $100,000 or less, and 47% of such loans for $100,000 to $250,000. In contrast, megabanks—those with over $50 billion in net assets—held just 16% of such loans for under $100,000 and 24% of loans for $100,000 to $250,000.[69]

Most small-business lending by banks has been in the form of loans guaranteed by the U.S. Small Business Administration (SBA). As discussed in detail below, SBA regulations impose interest rate caps and other substantive term regulations on the loans that help ensure that the loans are not abusive of the borrower.[70] Additionally, even when loans are not SBA-guaranteed, other soft factors mean that community banks are not as likely to impose unduly onerous terms in small-business loans.

64. *See* Peterson & Rajan, *supra* note 34, at 417, 440 ; Berger & Udell, *supra* note 34, at 354, 367.

65. Julia Kagan, *Loan Committee: What it is, Determining Loan Quality*, INVESTOPEDIA (Jan. 31, 2021), https://www.investopedia.com/terms/l/loan-committe.asp [https://perma.cc/S9S7-Z4T7].

66. *See supra* note 6, at 22-24 (describing the application decisioning process) and 27-33 (noting that large banks are more likely to use automated underwriting models).

67. *See* Allen N. Berger & Lamont K. Black, *Bank Size, Lending Technologies, and Small Business Finance*, 35 J. BANKING & FIN. 724, 724 (2011) (noting the prevalent view that "large banks tend to specialize in lending to relatively large, informationally transparent firms using "hard" information, while small banks have advantages in lending to smaller, less transparent firms using "soft" information").

68. There is significant regional variation, however, with larger banks playing a more important role in the Northeast. *See* Paul Calem, Francisco Covas & Benjamin Gross, *Bridging the Gap: How Larger and Mid-sized Banks Power Small Businesses*, BANK POLICY INSTITUTE 1, 4 (July 21, 2023) https://bpi.com/wp-content/uploads/2023/07/Bridging-the-Gap-How-Large-and-Mid-sized-Banks-Power-Small-Businesses.pdf [https://perma.cc/5L6S-X5NK].

69. BANKFIND SUITE, FDIC (database searched Jan. 28, 2025) (search results on file with author).

70. *See* 13 C.F.R. §§ 120.211-14 (2024).

Banks are regulated for safety and soundness. Excessive credit risk is inconsistent with safe and sound banking, and high-cost loans are a flag to regulators of a potentially high level of credit risk.

Community banks also face reputational constraints on their lending. Community banks have a physical presence in their communities and are repeat players in lending in their communities. They are often deeply engaged with their communities, sponsoring local cultural events and civic institutions. They also generally hope to cultivate long-term relationships with both small businesses and the businesses' owners for a variety of financial products, such as deposit accounts, auto loans, home mortgages, credit cards, and investment products. Indeed, a Federal Reserve System survey of small-business borrowers indicates that those who borrow from a bank are most often influenced by a pre-existing relationship with the bank.[71] All of this means that community banks are less likely to engage in abusive lending practices, at least within the communities where they are located.[72]

b. Fintechs

Fintech small-business lending is free of these regulatory and reputational constraints. A large part of fintech small-business lending is outside the scope of SBA guaranty programs. Fintechs by definition lack a brick-and-mortar presence in any community, so they are not as constrained by reputational factors. Indeed, a fintech that develops a bad reputation can easily rebrand.

Nor are fintech small-business lenders looking to develop broader, long-term relationships with small business and business owners. Fintech lenders typically offer only a single product line or a couple related products, so they cannot look to cross-sell customers by currying favor with them. Instead, fintechs are generally focused on maximizing their revenue from the immediate relationship. And because fintechs lack any particular expertise about local markets, their underwriting is, almost by necessity, based on limited financial attributes about the borrower, or more frequently about the borrower's owner-guarantor.

In this sense, fintech small-business lenders operate more like consumer lenders, undertaking more automated underwriting based on things like credit scores, than like traditional small-business lenders. Not surprisingly, fintech small-business lending has been concentrated on what

71. *2024 Report on Employer Firms: Findings from the 2023 Small-Business Credit Survey*, FED. RES. BANKS 14 (2024), https://www.fedsmallbusiness.org/reports/survey/2024/2024-report-on-employer-firms [https://perma.cc/FU7Y-LRGP].

72. A few community banks partner with fintechs to make high-cost loans *outside* of their communities. *See* Adam J. Levitin, *Rent-a-Bank*: *Bank Partnerships and the Evasion of Usury Laws*, 71 DUKE L.J. 329, 333-34 (2021) (discussing loans made in Florida and New York by Bank of Lake Mills, a two-branch bank in Wisconsin).

might be called the "subprime" part of the small-business lending market—borrowers with poorer or less established credit or in urgent need of funding.[73]

c. SBA Loan Guaranty Programs

Many small-business loans by a bank or finance company are partially guaranteed by the SBA.[74] The SBA has two main loan guaranty programs, Section 7(a) and Section 504.[75] Section 7(a) is the SBA's main loan guaranty program, guarantying approximately 70,200 loans for over $31.1 billion in the 2024 fiscal year, while the SBA guaranteed approximately 6,000 loans for $6.7 billion under the section 504 program that year.[76] Together, these programs account for nearly three-quarters of the total number of all SBA financings and 70% of the dollar amount.[77]

The Section 7(a) program under the Small Business Act of 1953 provides partial guaranties of loans to small businesses for up to $5 million.[78] Section 7(a) loans can be used for most purposes, including acquisition and improvement of capital assets, purchases of inventory and raw materials, and as working capital.[79]

The Section 7(a) program provides a 75% guaranty to private lenders for loans greater than $150,000 and an 85% guaranty for smaller loans.[80] The SBA guaranty is pro rata rather than first loss, so it is effectively a co-insurer, sharing losses with the lender. This forces the lender to have skin in the game on Section 7(a) loans.

73. *See 2024 Report on Employer Firms: Findings from the 2023 Small-Business Credit Survey*, *supra* note 26, at 13 (noting that borrowers with poorer credit were more likely to apply to fintech lenders than to any other type of financing institution).

74. The SBA does not generally make direct loans to small businesses, other than in declared disaster areas. *See* 13 C.F.R. § 123.5 (2024).

75. David D. Chait, *Small-Business Financing and the Post-2008 Credit Paradigm: the U.S. Small Business Administration and Key Factors to Support Traditional Credit Markets*, 6 ENTREPREN. BUS. L.J. 411, 426 (2011). The SBA also has a microlending program, a surety bond guaranty program, and a disaster loan program. Additionally, the SBA has a program where it provides matching funding to Small Business Investment Companies (SBICs) that make debt or equity investments in small businesses. 13 C.F.R. pt. 107 (2024). SBICs are licensed, privately owned investment funds, restricted to investing solely in domestic small businesses, that are able to access a SBA-backed credit facility via the Federal Home Loan Bank System. *Id.*

76. *2024 Capital Report*, SMALL BUS. ADMIN. (Oct. 2024), https://www.sba.gov/sites/default/files/2024-10/Capital%20Impact%20Report%202024_Final_0.pdf [https://perma.cc/QGA8-Z4EX].

77. *See id.* (noting 103,000 total SBA financings in fiscal year 2024, totaling $54.824 billion).

78. 15 U.S.C. § 636(a)(2)-(3) (2018); 13 C.F.R. § 120.151 (2024).

79. 13 C.F.R. § 120.120 (2024).

80. 15 U.S.C. § 636(a)(2)-(3) (2018); 13 C.F.R. § 120.210 (2024).

The SBA does not always require collateral,[81] only that the borrower be creditworthy, but in practice there is almost always a collateral requirement. For Section 7(a) loans of over $500,000, the SBA generally requires that the loan be "fully secured."[82] For loans of $50,000 to $500,000, the SBA requires that the lender follow the collateral policies and procedures it has for similarly-sized non-SBA-guaranteed commercial loans.[83] For Section 7(a) loans of under $50,000, the SBA does not require collateral,[84] but in all cases regardless of SBA requirements, the private lender will generally insist on collateral,[85] so the entire loan will typically be secured by a first lien on substantially all of the borrower's assets. The loan must also be personally guaranteed by any holder of at least a 20% interest in the borrower.[86]

Thus, if there is a default on a Section 7(a) loan, the private lender will generally liquidate the collateral and seek to collect on the personal guaranty if there is a shortfall in the collateral. Only if there is still a shortfall will the lender file a claim with the SBA, which will pay up to its pro rata guaranty on the liquidation losses. The SBA will then be subrogated to any outstanding claim that the lender would have against the borrower or its guarantor(s).[87]

The other major SBA lending program is the Section 504 program under the Small Business Investment Act of 1958. The Section 504 program provides long-term, fixed-rate, fully amortized financing. A Section 504 loan is only for financing the purchase, lease, improvement, or renovation of fixed assets such as equipment and real estate.[88] In other words, unlike a Section 7(a) loan, a Section 504 loan cannot be used to provide operating capital for a business. Instead, it is meant to be an economic development tool.

Section 504 financings are structured transactions: a private lender must provide 50% of the financing, secured by a senior lien on the property financed. A non-profit Certified Development Company then provides the next 40% in the form of a debenture secured by a second lien on the

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81. SBA Procedural Notice, Control No. 5000-846607 (May 9, 2023), https://www.sba.gov/sites/default/files/2023-08/2023.05.09%20Procedural%20Notice%205000-846607%20Implementation%20of%20Affiliation%20Rule-R.pdf [https://perma.cc/2L7M-R8HX].

82. *See Standard Operating Procedure 50 10, Version 7.1*, SMALL BUS. ADMIN. 113 (Nov. 15, 2023).

83. *Types of 7(a) Loans*, SMALL BUS. ADMIN. (Dec. 5, 2024), https://www.sba.gov/partners/lenders/7a-loan-program/types-7a-loans#id-standard-a [https://perma.cc/M4PU-P7BD].

84. *Id.*

85. *Do SBA 7(a) Loans Require Collateral?*, JANOVER (Feb. 19, 2023), https://www.sba7a.loans/sba-7a-loans-small-business-blog/sba-7a-loans-and-collateral-down-payment [https://perma.cc/FEY5-JFDE].

86. 13 C.F.R. § 120.160 (2024).

87. RESTATEMENT (THIRD) OF SURETEYSHIP AND GUARANTY § 27(1) (1996).

88. 13 C.F.R. § 120.802 (2024).

project.[89] The borrower provides the last 10% with an equity investment.[90] As with Section 7(a) loans, the section 504 debenture must be personally guaranteed by any holder of at least a 20% interest in the borrower.[91]

In a Section 504 financing, the SBA guarantees the entire debenture—the junior tranche of the financing—but not the senior tranche. The Certified Development Company will generally sell the debenture to an underwriter, which will bundle it with other SBA-guaranteed debentures, and securitize them.[92] Securitization of SBA-guaranteed Section 504 debentures is possible because the SBA guaranty standardizes the credit risk for investors in the securitized debentures, such that they do not need to undertake diligence about the underlying small-business borrowers. The securitization investors assume the credit risk of the SBA, while the SBA assumes the credit risk of the small business. A Section 504 debenture (40% of the total financing) is limited to $5.5 million, so the entire financing package with a Section 504 debenture is limited to $13.75 million.[93]

In both Section 7(a) and Section 504 programs, the private lender still has its own funds at risk, so the SBA is able to piggyback on the private lender's diligence and underwriting. This enables the SBA guaranty to operate as a multiplier on the amount of small-business credit available in the economy. Private lenders might be reluctant to lend beyond a certain dollar amount to any particular borrower. The SBA guaranty effectively enables larger loans to be made to small-business borrowers.

SBA loan guaranties are not free; lenders must pay the SBA a guaranty fee,[94] as well as a servicing fee.[95] The SBA loan guaranty program requires the SBA to set its guaranty fee at a level that will have no cost to the federal budget,[96] so the guaranty fee should reflect the risk assumed by the SBA overall on its portfolio, rather than a subsidized rate.

Critically, the SBA restricts the interest rates that may be charged on loans it guaranties,[97] and lenders are restricted in the type of fees they may charge the borrower and other terms of the loan.[98] SBA rate caps have the same effect as a usury law, in that they both protect the borrower and ration credit.

89. 13 C.F.R. § 120.801(c) (2024).
90. 13 C.F.R. §§ 120.2(c), 120.801 (2024).
91. 13 C.F.R. § 120.160 (2024).
92. 13 C.F.R. § 120.801 (2024).
93. 13 C.F.R. § 120.931 (2024).
94. 15 U.S.C. §636(a)(18)(A) (2018); 13 C.F.R. § 120.220 (2024).
95. 15 U.S.C. § 636(a)(23)(A) (2018).
96. 15 U.S.C. § 636(a)(23)(A) (2018).
97. 13 C.F.R. §§ 120.213, 120.214 (2024) (§ 7(a) loans); 120.932 (2024) (§ 504 loans). The SBA also restricts the interest rate on SBIC loans. 13 C.F.R. § 107.855 (2024) (restricting the interest rate on SBIC loans to the lower of 19% or 1100 basis points over the "Cost of Money," defined as the SBA's Debenture Rate or the SBIC's own Cost of Capital).
98. 13 C.F.R. §§ 120.212, 120.213, 120.221 (2024).

For Section 7(a) loans, the SBA requires the interest rate to be "reasonable,"[99] and it provides a rate cap at a spread over the market index rate. The spread varies by the size of the loan. For fixed-rate loans, the spread is between 500 and 800 basis points,[100] while for variable-rate loans it is between 300 and 650 basis points.[101]

For Section 504 financings, there are separate rate caps on the first lien (unguaranteed) and the second lien (SBA-guaranteed) loans. The SBA requires the rate on the first lien loan to be "reasonable"[102] and publishes a maximum allowed rate, currently the lower of 600 basis points over the "New York Prime rate" or the maximum rate allowed by applicable state law.[103] For second lien loans, the rate limit is more complex. The rate on all second lien loans made in a given month is identical. That rate is set based on the price at which the SBA is able to negotiate the sale of the debentures to underwriters for securitization plus fees to the Certified Development Corporation and loan servicer, as well as the SBA's guaranty fee.[104]

SBA regulations for both programs require that the borrower be creditworthy and the lenders use "appropriate and prudent generally acceptable commercial credit analysis processes and procedures consistent with those used for their similarly-sized, non-SBA guaranteed commercial loans."[105] The details of the credit underwriting, however, are left substantially up to the lenders. For section 7(a) lending, most lenders will insist not only on a pledge of collateral (not required by the SBA), but also on the business having an established history of at least two years in operation.[106] For Section 504 financings, the SBA itself requires a greater borrower equity contribution (reducing the guarantied debenture) if the borrower has been in operation for less than two years.[107]

SBA financing is effectively unavailable for three overlapping types of borrowers. First, SBA financing is generally unavailable for new

99. 13 C.F.R. § 120.213 (2024).

100. Maximum Allowable 7(a) Fixed Interest Rates, 87 Fed. Reg. 46883 (Aug. 1, 2022) (codified at 13 C.F.R. pt. 120 (2024)).

101. 13 C.F.R. § 120.214(d) (2024).

102. 13 C.F.R. § 120.921(b) (2024).

103. Notice, 89 Fed. Reg. 120 (Jan. 2, 2024).

104. The rate calculation begins with the debenture rate, which is a negotiated interest rate spread over the 10-year Treasury rate, determined each month. To that there is added a Certified Development Corporation fee of at least 62.5 basis points (capped at 200 basis points) plus a servicing fee of 10 basis points plus the SBA's guarantee fee of 36.4 basis points (or 38.9 basis points for a refinancing). *See SBA 504 Loan Debenture Rate: How Is the Interest Rate Determined*, ALLOY DEVELOPMENT CORP., https://alloydev.org/sba-504-loan-interest-rate-determined [https://perma.cc/VT75-YFER]; *How Are SBA 504 Interest Rates Determined*, GROWTH CORP., https://www.growthcorp.com/how-are-sba-504-interest-rates-determined [https://perma.cc/NU5J-HN68]. 13 C.F.R. § 120.971 (2024).

105. 13 C.F.R. § 120.150 (2024).

106. Melissa Wylie, *SBA 7(a) Loan: How to Get the Popular SBA Loan*, (Aug. 22, 2023) https://www.lendingtree.com/business/sba/sba-7a-loan [https://perma.cc/NMQ4-J8DA].

107. 13 C.F.R. § 120.910 (2024).

businesses. Section 7(a) financing is not available for new businesses because of private lenders' requirement of two years of business operations history and financials, while Section 504 financings are effectively unavailable because of the higher equity contribution required for new businesses. Instead, new businesses need to find other sources of credit.

Second, SBA financing is not available for borrowers who lack sufficient collateral to pledge. The insistence of private lenders on having a first lien on adequate collateral prevents some small businesses, particularly service-based businesses, from obtaining SBA-guaranteed loans.

Third, SBA financing is not available for riskier businesses. For some businesses this is because they are too risky for any prudent lender to lend to them. For others, however, it is because they are merely too risky for a prudent lender to lend to them at an interest rate under the SBA rate cap.

Thus consider the situation of Maguire's, a boutique sandwich shop in Pennsylvania owned by Joe Maguire that has been in operation for a year. As a journalistic account explains:

> Mr. Maguire probably cannot turn to a bank. He has two strikes against him: he hasn't been in business for at least two years, and, unless he is one of the lucky few with equity in their houses, he has no collateral for a loan. The bankers aren't interested in the coffee urns or the coolers holding Snapple.[108]

SBA-guaranteed financing is simply not an option for small businesses that are new, lack ready collateral, or are otherwise high-risk. The SBA is not the entirety of the market, however, so borrowers unable to obtain SBA-guaranteed loans can still turn to other lenders for credit.

4. Sales-Based Financing and Merchant Cash Advances

In addition to traditional loans, small businesses sometimes obtain "sales-based financing." These are transactions that involve either the sale of the business's future receivables or loans with repayment keyed to the borrower's sales. Sales-based financing differs from invoice factoring in that it involves the sale of *future* receivables, and hence the risk of whether and when those receivables will be created, as opposed to factoring, which involves transferring the collection risk on *existing* receivables.[109]

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108. Ami Kassar, *What You Need to Know About Merchant Cash Advances*, N.Y. TIMES (Oct. 30, 2012), https://archive.nytimes.com/boss.blogs.nytimes.com/2012/10/30/what-you-need-to-know-about-merchant-cash-advances [https://perma.cc/GBB4-UXQK].

109. The SBA permits SBICs to offer sales-based financing, but treats the transactions as loans for regulatory purposes, caps the amount of the advance at 19% of the small business's annual gross revenue and subjects the advances to an interest rate cap. 13 C.F.R. §§ 107.810, 107.855 (2024). It is unclear how much sales-based financing is done by SBICs.

a. Merchant Cash Advances

The most common type of sales-based financing is a "merchant cash advance" or "MCA." MCAs have existed since at least the end of the twentieth century,[110] but their popularity increased sharply after the 2008 financial crisis,[111] as banks have tightened lending standards for smaller businesses.[112]

In an MCA transaction, the business will sell a fixed dollar amount of its future sales to the MCA provider at a discount. Critically, the sale is not of the receivables itself—and hence a transfer of the collection risk—rather, the sale is of a fixed amount of funds collected on those receivables.[113] What matters is not the total receivables, but the total collections by the small business.

Part of the business's collections on future sales is then periodically transferred to the MCA provider until the provider has received the purchased amount of future sales revenue. Frequently, an MCA is limited to a purchase of future sales made via payment card because the merchant's payments processor provides a reliable source of data on the sales and may even automatically debit payments on the MCA for the MCA provider.

MCAs are structured to give the small business a lump sum advance.[114] This payment is sometimes known as the "advance amount." The "payback amount" that the small business is then expected to pay the purchaser is the advance amount multiplied by a "factor" plus certain fees.[115] The factor typically ranges from 1.1 to 1.5,[116] with higher rates corresponding with longer repayment periods. For example, an advance amount of $100,000 with a factor of 1.4 would mean that the payback amount would be $140,000. In other words, the payback amount is a markup of the advance amount. The payback amount is the amount of the future receivables that are supposedly purchased by the MCA provider.

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110. Grant Phillips, *Merchant Cash Advance: A History,* https://grantphillipslaw.com/who-created-a-merchant-cash-advance-a-short-history [https://perma.cc/5B4M-UXUA] (noting Barbara S. Johnson's 1997 patent for split funding for payments received by a payment card processor).

111. Mark K. Singla, *MCAs: Lifesavers, or Debt Traps?*, 42-11 AM. BANKR. INST. J. 36, 36 (2023).

112. *Merchant Cash Advance Loans - Frequently Asked Questions*, J. SINGER L. GRP., https://www.singerlawgroup.com/merchant-cash-advance-loans-a-comprehensive-guide-for-businesses [https://perma.cc/U3H9-H9RD].

113. *Id.*

114. *Id.*

115. *See, e.g.*, *What Is MCA Factor Rate?*, ECAPITAL, https://ecapital.com/financial-term/mca-factor-rate [https://perma.cc/M3B4-U8GL].

116. *Invoice Factoring vs. Merchant Cash Advances: Choosing the Right Funding Solution*, ECAPITAL, https://ecapital.com/blog/invoice-factoring-vs-merchant-cash-advances-choosing-the-right-funding-solution [https://perma.cc/YYX6-C9LU]; *see also* Stevens, *supra* note 36, at 515.

Although MCAs claim to be discounted purchases of receivables, the marking up the advance amount to calculate the payback amount suggests that they are in fact more akin to a loan, with the markup based on the funding amount constituting the finance charge—the cost of the advance of the funds. A real discounted purchase would start with the amount of receivables purchased and then calculate a discount from the face, rather than marking up the amount advanced to equal the putative receivables purchased.

In addition to the markup of the advanced amount, MCAs often come with other fees: origination fees, underwriting fees, risk assessment fees, facility fees, wire fees, ACH fees, funding fees, administrative fees, etc.[117]

The repayment of the payback amount is based on a holdback percentage (which goes by different names) of the merchant's sales. In some cases, this means that the periodic payment is simply the holdback percentage multiplied by the specified receivables. For example, a merchant might be required to remit 28% of its receipts every day.[118] In such instances, if the merchant's sales are up in a given period, the merchant will pay back more of the advance, and if they are lower, then the merchant will pay back less. In such instances, the speed of repayment will vary with the merchant's sales volume.

In other cases, however, the merchant is required to remit a fixed periodic amount, just as with a typical loan. That fixed amount is derived from an application of a holdback percentage to *estimated* future periodic income, but the actual payment does not vary with the merchant's sales.[119]

Some MCAs have a "reconciliation" or "true-up" provision that enables an adjustment of the holdback percentage at the small business's request if it is finding the payments too onerous.[120] Despite the specialized terminology, a true-up is merely a formalized mechanism for amending a

117. *Merchant Cash Advance Costs: What You Need to Know*, ECS PAYMENTS (May 13, 2024), https://www.ecspayments.com/merchant-cash-advance-costs [https://perma.cc/ZMM4-N7NS]; Anthony Rumore, *How to Know if Your Merchant Cash Advance is Bad*, BUS. DEBT LAW GRP. (Feb 2024), https://businessdebtlawgroup.com/merchant-cash-advance-bad [https://perma.cc/YHU9-AQ2Y].

118. Defendant's Motion for Summary Judgment at 993, Small Bus. Fin. Ass'n v. Hewlett, No. 2:22-cv-08775 (C.D. Cal. Sept. 27, 2023) (displaying Rapid Finance's offer summary for "Future Receivables Sales") [hereinafter "Rapid Finance MCA"].

119. *See, e.g.*, Defendant's Motion for Summary Judgment at 1031, Small Bus. Fin. Ass'n v. Hewlett, No. 2:22-cv-08775 (C.D. Cal. Sept. 27, 2023) (presenting Kapitus LLC's offer summary for a "Forward Purchase Agreement (Fixed)") [hereinafter "Kapitus MCA"].

120. Defendant's Motion for Summary Judgment at 871, Small Bus. Fin. Ass'n v. Hewlett, No. 2:22-cv-08775 (C.D. Cal. Sept. 27, 2023) ("Admitted that SBFA's members' sales-based financing agreements that provide for "variable" remittances do not contain a true-up mechanism, as such a mechanism is not essential for these types of sales-based financing agreements."); *see also*, *e.g.*, Kapitus MCA, *supra* note 119, at 1033 (presenting the terms of Kapitus's Forward Purchase Agreement); Defendant's Motion for Summary Judgment at 1020, Small Bus. Fin. Ass'n v. Hewlett, No. 2:22-cv-08775 (C.D. Cal. Sept. 27, 2023) (presenting Forward Financing's "Future Receipts Sales Agreement") [hereinafter "Forward Financing MCA"].

contract, and not all MCAs have true-ups.[121] For those that do, the true-up is never automatic and self-executing. Instead, it is a process that must be invoked by the small business. There is considerable variation in what the small business must do to invoke a true-up, and the particular terms can render the reconciliation right illusory.[122] Even then, however, whether to grant the true-up and to what extent is discretionary to the MCA provider.[123]

In some cases, the discretion is express, but in other cases it is more subtle. For example, a MCA from Forward Financing provides that if there is a true-up request, "[p]rovided that the information provided by the Customer supports the requested Adjusted Weekly Amount, Purchaser shall make the adjustment for a period of 14 days."[124] Although the use of the word "shall" would make the true-up provision seem of right, not discretionary, it is all dependent on the Purchaser, Forward Financing, determining that the information provided supports the requested adjustment. In other words, granting the true-up requested is discretionary to Forward Financing. At most, the right to the true-up is policed by the

121. *See, e.g.*, Rapid Finance MCA, *supra* note 118, at 996 (holdback of 28% of daily receivables with no true-up provision).

122. *See, e.g.*, Lateral Recovery, LLC v. Cap. Mech. Servs. LLC., 632 F. Supp. 3d 402, 458 (S.D.N.Y. 2022) ("The agreement nominally has a reconciliation provision . . . but that reconciliation provision is illusory. It can be invoked only at the discretion of the funder and, even then, because it can be invoked only five business days after the calendar month."); Lateral Recovery LLC v. Funderz.net LLC, 2024 U.S. Dist. LEXIS 176985, at *77-78 (S.D.N.Y. Sept. 27, 2024) (finding MCAs to be loans as a matter of law where "[e]ven assuming accounts can be reconciled at the end of the each month . . . the agreement specifically states that a non-sufficient funds fee will be charged 'up to TWO TIMES' [o]nly before a default is declared," and stating that "Therefore, if FTE's receivables took a downturn, it would continue to be responsible for the same daily payments, and if it was unable to make the payments Funderz would be able to declare a default at any time."); Akf, Inc. v. Haven Transp. Bus. Solls., Inc., 2024 U.S. Dist. LEXIS 103271, at *17 (N.D.N.Y. June 11, 2024) ("[T]he Agreement defines the failure to pay the weekly Delivery Amount as an irremediable infraction that foreclosed any possibility of future reconciliation. As such, any reconciliation under the Agreement was very unlikely and difficult to obtain, and this factor weighs in favor of finding that the Agreement constituted a loan.").

123. George Joseph & Ben Brachfeld, *New York Businesses Say Cash Advance Firms Sent Threats and Looted Bank Accounts*, THE CITY (Sept. 22, 2022), https://www.thecity.nyc/2022/09/21/merchant-cash-advance-new-york-threats-courts [https://perma.cc/9UDG-M3CC] (noting allegation that MCA provider treated a true-up request "as if it were a negotiation, rather than a contractually-mandated calculation based on his bank statements"); Lateral Recovery LLC v. Queen Funding LLC, 2022 U.S. Dist. LEXIS 129032, at *14-15 (S.D.N.Y. July 20, 2022) ("[A]ny [reconciliation] obligation that Queen Funding may have is contingent on the merchant's providing documentation requested by Queen Funding 'in its sole judgment' and in its 'sole and absolute discretion,' respectively. Queen Funding consequently has the absolute ability to nullify any obligation to reconcile."); Lateral Recovery LLC v. Funderz.net LLC, 2024 U.S. Dist. LEXIS 176985, at *75 (S.D.N.Y. Sept. 27, 2024) (similar).

124. Forward Financing MCA., *supra* note 120, at 1020 (presenting the terms and conditions of Forward Financing's "Sales's Agreement"); *see also* Kapitus MCA, *supra* note 119, at 1033 (stating that "[u]pon verification of the Receipts generated by Seller, Servicer shall adjust the Specified Amount on a going-forward basis to more closely reflect the Seller's actual Receipts," but still leaving the adjustment to the discretion of the Seller because it must consent to the adjustment).

covenant of good faith and fair dealing, an ex-post litigation right that is of cold comfort to a merchant denied a true-up.

MCA providers frequently take a security interest in various assets of the small business, not just in the assets that are allegedly being purchased.[125] MCAs are also almost invariably guaranteed by the small business's owner, and the MCAs are underwritten based in part on the personal credit of the small-business owner.[126] Indeed, some MCA providers refer to the small-business owner as the client.[127]

MCAs are a product used exclusively by small businesses, but only a minority of small businesses use them, and they are primarily riskier or less-established ones. Only 8% of small businesses with non-owner employees apply for MCAs,[128] but this translates to approximately 440,000 small businesses with employees seeking MCA financing every year.[129] It is unknown how many small businesses without employees apply for MCAs; data on the industry is limited.

MCA financings tend to be for smaller amounts and are more expensive than bank loans,[130] although this might merely reflect the smaller size and weaker financial condition of businesses that apply for MCAs.[131] As one small business finance company that does not provide MCAs explains, "MCAs are typically used as a last resort for small, quick financing arrangements that can be repaid in a short amount of time."[132]

MCAs have several appealing aspects to small businesses relative to straight loans. First, they are quicker to obtain than other forms of

125. *See, e.g.*, Kapitus MCA, *supra* note 119, at 1044 (security interest in various assets including accounts, inventory, goods, and general intangibles).

126. Scott J. Bogucki, *MCA Transactions: True Sale or Disguised Loan?*, 41-12 AM. BANKR. INST. J. 26, 26 (2023); Defendant's Motion for Summary Judgment at 1108, Small Bus. Fin. Ass'n v. Hewlett, No. 2:22-cv-08775 (C.D. Cal. Sept. 27, 2023) (expert report of Professor Adam J. Levitin noting the use of personal credit reports by Kapitus and the review of personal credit report and credit score by Rapid Finance). *See also* Treece, *supra* note 62.

127. Defendant's Motion for Summary Judgment at 1108, Small Bus. Fin. Ass'n v. Hewlett, No. 2:22-cv-08775 (C.D. Cal. Sept. 27, 2023) (expert report of Professor Adam J. Levitin noting the Kapitus underwriting manual's reference to "the business or the client").

128. *Small-Business Credit Survey, 2024 Report on Employer Firms: Findings from the 2023 Small-Business Credit Survey*, FED. RESERVE SYS. 10 (2024).

129. 440,000 is 8% of 5.5 million small businesses with non-owner employees. *See* Off. of Advoc., *2023 Small Business Profile*, U.S. SMALL BUS. ADMIN., https://advocacy.sba.gov/wp-content/uploads/2023/11/2023-Small-Business-Economic-Profile-US.pdf [https://perma.cc/98PJ-TWRZ] (number of firms).

130. *Merchant Cash Advances vs. Business Loans — What's the Difference?*, FORWARD FINANCING (Sept. 13, 2023), https://www.forwardfinancing.com/merchant-cash-advances-vs-business-loans-whats-the-difference [https://perma.cc/VDU2-QE3Y] ("Typically, a traditional business loan – usually from a bank or a credit union – will be less costly than an MC . . . ."); *Financing Your Small Business With a Merchant Cash Advance*, KAPITUS 8, https://kapitus.com/wp-content/uploads/2019/11/MCA_eGuide.pdf [https://perma.cc/MTN5-U3N3] ("[M]erchant cash advances can end up being a much more expensive borrowing option than other kinds of financing.").

131. *Why It's Different*, WHAT IS REVENUE-BASED FINANCING? https://whatisrevenuebasedfinancing.com/why-its-different [https://perma.cc/74YQ-TSM2].

132. *Invoice Factoring*, *supra* note 116.

financing. Small businesses can apply on-line and get approved and funded within days, as opposed to months for a bank loan.[133]

Second, MCAs are easier for small businesses with poor or limited credit histories to obtain than traditional forms of small-business financing. MCAs do not generally require the extended business operation history needed for obtaining a small-business loan,[134] and a 2023 Federal Reserve Board survey of small-business credit found that the approval rate for MCAs (90%) was higher than for any other common form of small-business financing.[135]

Third, there are generally no restrictions on how the funding from an MCA can be used, unlike many other small-business financing products.[136] This flexibility is attractive to businesses.

Fourth, some MCAs have a different payment structure than traditional loans. Although the periodic payment for some MCAs is a fixed dollar amount like a traditional loan,[137] for others it is based on a percentage of the merchant's sales (typically just payment card transactions). For MCAs with a variable payment amount, the small business's payment obligations rise and fall with its sales revenue stream, which can be attractive to merchants with seasonal sales (*e.g.*, Christmas, summer), and it relieves merchants of the pressure to make a fixed payment when business is bad.[138] The flip side, however, with variable payment amounts is that there is uncertainty about precisely when the small business will manage to pay off the MCA; lower sales mean a longer payback period and likely a larger markup.

Whereas SBA-guaranteed loans are made primarily, although not exclusively, by banks, MCAs are provided entirely by non-bank finance companies that connect with borrowers on-line (including through

133. *What is a Merchant Cash Advance?*, MCASHADVANCE, https://www.mcashadvance.com [https://perma.cc/8KKW-B4HM] ("Same day funding is possible when you apply for an MCA. Receive your cash in as little as 24 hours. Our average funding time is 1-3 days."); *Business Loan Options*, KAPITUS, https://kapitus.com/business-loan-options [https://perma.cc/6CDZ-PWXR] (advertising "[d]ecisions in as little as 4 [h]ours").

134. *See, e.g., What is a Merchant Cash Advance?*, MCASHADVANCE, https://www.mcashadvance.com [https://perma.cc/GGL9-T3MX] (presenting application criteria which do not include business operation history); *Get business financing in as little as 4 hours*, CREDIBLY, https://partner.credibly.com/fintel [https://perma.cc/C7L3-AVK7] (same).

135. *Small-business credit Survey, 2023 Report on Employer Firms*, FED. RESERVE SYS. 17, https://www.fedsmallbusiness.org/-/media/project/smallbizcredittenant/fedsmallbusinesssite/fedsmallbusiness/files/2023/2023_sbcs-employer-firms.pdf [https://perma.cc/3DFX-6ZE9].

136. *Everything You Need to Know About a Merchant Cash Advance*, RAPID FINANCE, https://www.rapidfinance.com/blog/everything-you-need-to-know-about-a-merchant-cash-advance [https://perma.cc/R58U-JFP9].

137. *See, e.g.*, Kapitus MCA, *supra* note 119, at 1033 (requiring a fixed payment amount).

138. *Id.*

brokers[139]). This means that MCA providers lack the reputational and regulatory constraints of community banks that dominate traditional small-business lending.

b. Merchant Cash Advances as Disguised Loans

MCAs purport to be merely sales of future receivables, not loans, but the economic reality is that they are almost always loans.[140] Perhaps

139. MCA brokers are sometimes called independent sales organizations or ISOs. MCA brokers are compensated by MCA providers to find customers for them. Typically, an MCA broker receives a commission from the MCA provider of between 5% and 15% of the funded amount, which is locked in after the merchant makes timely payments for a month. *Decoding ISO Broker Compensation: Navigating the Salary Range Landscape*, NEWCO. CAP. GRP., https://www.newcocapitalgroup.com/post/decoding-iso-broker-compensation-navigating-the-salary-range-landscape [https://perma.cc/T9GV-NMWP] (citing a 5%-15% commission); *Power of Attorney in MCA Contracts? Also, the Latest on Clawbacks and PSFs*, FUNDER INTEL (Aug. 28, 2021) https://www.funderintel.com/post/power-of-attorney-making-a-comeback-also-whats-new-with-clawbacks-and-psfs [https://perma.cc/TNL5-683B] (citing a 30-day commission clawback period as standard). The commission is usually based on the factor rate with a higher factor rate (or longer term) resulting in higher broker compensation. *See, e.g.*, ISO (Independent Sales Organization) Agreement at 1, DFL Consulting, LLC v. Texas Medical Technology, LLC, No. 804182/2022 (N.Y. Sup. Ct. June 7, 2023) (citing the Jett Capital ISO Agreement, showing higher points paid for higher factor rates). The situation here is similar to that of now banned yield-spread premiums in mortgages. *See generally* Laurie Burlingame & Howell E. Jackson, *Kickbacks or Compensation: The Case of Yield Spread Premiums*, 12 STAN. J. L. BUS. & FIN. 289 (2007) (describing the operation of yield spread premiums); 15 U.S.C. § 1639b(c)(1) (2018) (banning yield spread premiums). Brokers also sometimes charge the borrower a commission, mark up the factor rate, or, in some instances, take a piece of the MCA through a syndication, so that they also make money on the MCA itself.

140. The idea that a sale could be a loan is not intuitive at first glance, but jurisprudence has historically treated a discounted sale of a payment obligation made with recourse against the seller as a loan. Adam J. Levitin, Spurious Pedigree of the "Valid-When-Made" Doctrine, 71 Duke L.J. Online 87, 97 (2022) (explaining how a discounted sale of a receivable, with recourse to the seller has historically been considered a loan). California courts have declined to treat as loans traditional factoring contracts—sales of existing (as opposed to future) receivables—that are made without recourse beyond the receivables purchased. West Pico Furniture Co. v. Pac. Fin. Loans, 2 Cal.3d 594, 601-06 (1970). Historically, a common transaction was the discounted sale of a note with recourse against the seller. Frequently, this was done through sale by indorsement—the practice of the seller of the note signing his name on the back (Latin: in dorso) of the note prior to delivering it to the buyer. Indorsement would make the seller co-liable on the note in its face amount, as it does under Article 3 the current Uniform Commercial Code, UCC §§ 3-204, 3-415, meaning that if the transaction was not really a sale at a discount, but a loan in which the discounted amount was the finance charge that for which the indorser was liable.

Thus, if the seller indorsed a note from obligor due in one year with a face amount of $120 and a 0% interest rate for $100 (with the discount reflecting repayment risk), it is equivalent to the buyer making a $100 loan to the seller at 20% annual simple interest. In either case, the buyer would have parted with $100 and would have a right to collect $120 in a year, from either the obligor or the seller. Thus, when a note is sold at a discount from its face amount, the discount can be treated as imputed prepaid interest. See, e.g., Nat'l Bank v. Johnson, 104 U.S. 271, 276-77 (1881); Evans v. Nat'l Bank of Savannah, 251 U.S. 108, 114 (1919). See also Daniel v. First Nat'l Bank of Birmingham, 227 F.2d 353, 355-56 (5th Cir. 1955) (addressing whether a discount was usurious), reh'g denied with opinion, 228 F.2d 803 (5th Cir. 1956).

The idea that a discounted sale can be equivalent to a loan is reflected in the current federal usury statutes for national banks and FDIC-insured state-chartered banks, both of which expressly cover loans and discounted sales of receivables. 12 U.S.C. §§ 85, 1831d(a). (2018). So too do many state usury laws, and the idea is preserved in the terminology of bank borrowing from the Federal surprisingly, the line between a sale and loan is not well-defined. The Uniform Commercial Code avoids "difficult problems of distinguishing between transactions in which a receivable secures an obligation and those in which the receivable has been sold outright,"[141] and it does not "provide rules for distinguishing sales transactions from those that create a security interest securing an obligation."[142] Instead, the matter is left to the courts.

Neither courts nor commentators, however, have arrived at a consensus about precisely what distinguishes a true sale from a secured loan in the context of a transfer of receivables,[143] and the tests use can vary depending on the purposes (e.g., determining title, bank regulatory capital requirements, tax liability, financial accounting). Although there is some difference in the nuances of the evaluation metrics used, most analyses have involved the use of multiple factors.[144] Those factors, however, can largely be reduced to three categories: (1) whether the "buyer" has the right to any excess revenue from the receivables,[145] (2) whether the "buyer" has recourse against the "seller" beyond the receivables themselves,[146] and (3) whether the "seller" retains control over the receivables.[147]

Applying various tests, courts have split on whether MCAs are loans or sales,[148] although many of the opinions on the matter are from New

Reserve System's "discount window," where the Federal Reserve System makes loans in the form of a discounted purchase with recourse of obligations owed to a bank.

141. UCC § 9-109, Cmt. 4.

142. UCC § 9-109, Cmt. 5.

143. *See* Steven L. Harris & Charles W. Mooney, Jr., *When Is a Dog's Tail Not a Leg?: A Property-Based Methodology for Distinguishing Sales of Receivables from Security Interests for Distinguishing Sales of Receivables from Security Interests That Secure an Obligation*, 82 U. CINCINN. L. REV. 1029, 1031 (2014) (noting lack of consensus); Heather Hughes, *Property and the True-Sale Doctrine*, 19 U. PENN. J. BUS. L. 870, 901 (2017) ("Case law addressing the true-sale doctrine is confusing, inconsistent, and sometimes incoherent.").

144. *See* JOHN FRANCES HILSON, ASSET-BASED LENDING: A PRACTICAL GUIDE TO SECURED FINANCING § 2:5.3 (2013) (identifying 15 factors considered by courts, but underscoring that the most important are recourse to the seller, the seller's collection of the receivables, the seller's holding and ability to commingle the receivables, the purchase price, how the parties books reflect the transactions, and the buyer's potential excess collections on the receivables).

145. Harris & Mooney, *supra* note 143, at 1063-64, 1069-72 (emphasizing the importance of the right to excess payments as a factor distinguishing true sales and loans).

146. STEVEN L. SCHWARCZ, STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION § 4:2 (Adam D. Ford ed., 2010) ("The most significant factor in the true sale de termination appears to be the nature and extent of recourse that the transferee of the receivables has against the transferor.").

147. *Statement of Financial Accounting Standards No. 167: Amendments to FASB Interpretation No. 46(R)*, FIN. ACCT. STANDARDS BD. 2 (June 2009), https://fasb.org/page/ShowPdf?path=fas167.pdf&title=FAS%20167%20(as%20issued) [https://perma.cc/E62K-CY4U].

148. *Cf. e.g.*, Lateral Recovery LLC v. Funderz.net, LLC, 2024 U.S. Dist. LEXIS 176985, at *70-96 (S.D.N.Y. Sept. 27, 2024) (finding that some of the MCAs at issue were loans); Crystal Springs Capital, Inc. v. Big Thicket Coin, LLC, 220 A.D.3d 745, 746-48 (N.Y. App. Div. 3rd Dept. 2023) (affirming that MCA was a loan); Lateral Recovery LLC v. Capital Merchant Services, LLC, 2022 U.S. Dist. LEXIS 181044, at *63 (S.D.N.Y. Sep. 30, 2022) (affirming that MCA was a loan);

York state trial courts that often apply only a cursory analysis that credits the formal provisions of MCA contracts.[149]

The result from any of these analytical focuses is the same: most MCAs are loans, in that they are not actually a transfer of receivables, but actually a contract for payment of a sum certain now in exchange for another sum certain later. Although the MCA industry likes to claim that the transactions are sales of future receivables—and most MCA agreements expressly disclaim the transactions being loans—the transactions are not in fact in *receivables,* that is obligations owed to the

Fleetwood Services v. Ram Capital Funding LLC, 2022 U.S. Dist. LEXIS 100837, at *21 (S.D.N.Y. June 6, 2022), *aff'd*, Fleetwood Servs., LLC v. Richmond Capital Grp. LLC, 2023 U.S. App. LEXIS 14241 (2d Cir. June 8, 2023) (same); New Y-Capp v. Arch Cap. Funding LLC, 2022 U.S. Dist. LEXIS 180309, at *13 (S.D.N.Y. Sept. 30, 2022) (same); Lateral Recovery, LLC v. Cap. Mech. Servs. LLC., 632 F. Supp. 3d 402, 454 (S.D.N.Y. 2022) (same); CapCall, LLC v. Foster (*In re* Shoot The Moon, LLC), 635 B.R. 797, 816 (Bankr. D. Mont. 2021) (same); Davis v. Richmond Cap. Grp. LLC, 194 A.D.3d 516, 517 (N.Y. App. Div. 1st Dept. 2021) (same); LG Funding, LLC v United Senior Props. of Olathe, LLC, 181 A.D.3d 664, 666 (N.Y. 2d App. Div. 2020) (finding that MCA is not a loan); *with* Principis Cap., LLC v. I Do, Inc., 201 A.D.3d 752, 754 (N.Y. 2d App. Div. 2022) (MCA not a loan); DMKA LLC v. Yellow Steel Inc., 2025 N.Y. Misc. LEXIS 408, at *6-7 (N.Y. Sup. Ct. Kings County, Jan. 21, 2025) (same).

149. New York courts generally apply a non-exhaustive three-factor test to determine whether an MCA is a loan: "(1) whether there is a reconciliation provision in the agreement; (2) whether the agreement has a finite term; and (3) whether there is any recourse should the merchant declare bankruptcy." Fleetwood Servs., LLC v. Richmond Cap. Grp. LLC, 2023 U.S. App. LEXIS 14241, at *1 (2d Cir. June 8, 2023). New York courts have also considered, however: whether MCA providers made sure merchants were in default immediately; whether the MCA identified particular revenue or accounts that were supposedly purchased; whether the merchant is responsible for collecting the future receipts; whether default is declared after just a few missed payments; whether the daily payment rates appear to be good faith estimates of merchant's receivables or is set unduly low; and whether the MCA agreements are underwritten like loans. *E.g.*, People v. Richmond Cap. Grp. LLC, No. 451368/2020, slip op. at *1 (N.Y. Sup. Ct. 2023); Lateral Recovery LLC v. Funderz.Net, LLC, 2024 U.S. Dist. LEXIS 10134, at *25-35 (S.D.N.Y. Jan. 19, 2024); LG Funding, LLC v. United Senior Properties of Olathe, LLC, 181 A.D.3d 664, 666 (2d Dep't 2020); Davis v. Richmond Capital Group, 194 A.D.3d 516, 517 (1st Dep't 2021); Haymount Urgent Care PC v. GoFund Advance, LLC, 609 F. Supp. 3d 237, 249 (S.D.N.Y. 2022); Lateral Recovery LLC v. Queen Funding LLC, 2022 U.S. Dist. LEXIS 129032, at *12-13 (S.D.N.Y. July 20, 2022); Lateral Recovery, LLC v. Cap. Mech. Servs. LLC., 632 F. Supp. 3d 402, 418, 454-455, 462 (S.D.N.Y. 2022); Singh v. LCF Group, Inc., 2023 N.Y. Misc. LEXIS 5285, at *5-6 (Sup. Ct. July 25, 2023).

The three-factor New York test is fundamentally formalistic, looking to define a loan by the presence of certain contractual provisions, rather than by its underlying economics, under which a loan boils down to an extension of money now for a promise repayment of money later. Such a formalist approach is at odds with the long tradition of usury law jurisprudence in New York and elsewhere that looks to the economic reality behind a transaction, not its form, lest form be used as a method of evasion. *See* Levitin, *Rent-a-Bank*, *supra* note 72, at 395-97 (citing Spitzer v. Cnty. Bank of Rehoboth Beach, 45 A.D.3d 1136, 1138 (N.Y. App. Div. 2007) ("We must look to the reality of the arrangement and not the written characterization that the parties seek to give it, much like Frank Lloyd Wright's aphorism that 'form follows function.' Thus, an examination of the totality of the circumstances surrounding this type of business association must be used to determine who is the 'true lender,' with the key factor being 'who had the predominant economic interest' in the transactions."). By constraining itself to three particular elements, the New York courts' test all but invites evasion of the New York usury statute by instructing MCA providers that as long as they check the box on three particular contract provisions they can avoid loan status, irrespective of other terms of the MCA.

merchant, but in *receipts*, that is money already collected by the merchant or its payment processor.[150]

For example, a Forward Financing MCA states that it is a sale of "Future Receipts," which it defines as "any payment received from customers and other third-party payors in exchange for Customer's goods and services, including payment received in any form including, but not limited to, cash, check, payment card and electronic transfers."[151] Thus what has been sold are not "receivables," meaning obligations to pay, but actual receipts, meaning collections that have been made on receivables. These receipts are simply fungible cash balance in deposit accounts. In other words, the MCA is an exchange of money now for a larger amount of money later. That is the very essence of a loan, with the difference in the sums being the finance charge.

Some MCAs purport to be sales of "receivables" rather than "receipts," but a closer look at the functioning of the MCA contract makes clear that what the merchant must deliver to the MCA provider are not receivables, but actual funds received. For example, a Rapid Finance MCA states that it is a sale of the "Daily Percentage of . . . Merchant's future accounts and contract rights arising from or relating to the use by the Merchant's customers of any Payment Device . . .to purchase Merchant's products and/or services that are processed by Merchants' card processor anytime during which the Amount Sold is outstanding ("Future Receivables")."[152] Yet the MCA contract goes on to provide that "Merchant agrees to remit to Purchaser in accordance with the terms of this Agreement the Daily Percentage of the Future Receivables specified above until the Amount Sold has been forwarded to Purchaser."[153] The remittance can be either "(i) directly from Merchant's card processor; (ii) by debiting the Merchant's bank account; or (iii) by debiting a deposit account established by Merchant that is approved by Purchaser."[154] In other words, what the small business is required to deliver to the MCA provider is not the actual receivable—that is the right to payment from an obligor—but the cash proceeds of the receivable once the receivable has already been collected, up to the payback amount. This is not simply a matter of which party is responsible for collection; instead, the obligation of the merchant is to tender the receipts, not the receivables, so the MCA provider never assumes the risk of collection on the receivable.[155]

150. Nor are these even payable solely from a particular pool of funds given the recourse provisions in MCAs.

151. Forward Financing MCA, *supra* note 120, at 1019.

152. Rapid Finance MCA, *supra* note 118, at 996.

153. *Id*.

154. Rapid Finance MCA, *supra* note 118, at 998.

155. This factor has contributed to some courts finding MCAs to be loans. Haymount Urgent Care PC v. GoFund Advance, LLC, 609 F. Supp. 3d 237, 249 (S.D.N.Y. 2022) ("[T]he MCA agreements leave merchants with the responsibility to collect revenues from all their

If the transfer obligation actually were for specific receivables, the MCA provider would be incurring the risk of the collectability of those receivables, the risk of any chargebacks on the receivables, and would have the right to any excess collections (e.g., recovery of attorneys' fees spent in collecting the receivables). That is not how an MCA transaction actually works, however. Instead, all the collection risk (including chargeback risk) and all the right to excess collections on the receivables remain with the small business; the MCA provider never incurs any risk on the receivables nor receives any upside benefit. Recognition of what is actually being "purchased" in an MCA transaction underscores that from an "excess payment" analysis, MCAs are financings, not sales.

Consideration of recourse produces the same conclusion. MCAs, other than those made by platform fintechs, are always made with recourse to assets other than the purchased receivables.[156] If the MCA is made with recourse to assets other than those purchased, it is no longer merely a discounted sale of an asset, but an advance of funds with a requirement to repay with a finance charge.

MCAs contain recourse to assets beyond those purchased in three ways. First, MCAs often contain a security interest in assets of the small business and the guarantor that exceeds the scope of the receivables allegedly "purchased."[157] A true "sale" would not be secured by assets other than those purchased.

Second, MCAs contain warranties that effectively ensure that the small business will be in default and its other assets will therefore be on the line if it fails to generate sufficient revenue. For example, an MCA contract from Kapitus LLC provides that the small business warrants that it "is a valid business in good standing under the laws of the jurisdictions in which

accounts . . . . All these features of the MCA agreements are more consistent with an 'intent to borrow' a fixed sum through a loan."); Lateral Recovery LLC v. Funderz.net LLC, 2024 U.S. Dist. LEXIS 176985, at *82 (S.D.N.Y. Sept. 27, 2024) (finding that MCA agreement is a loan as a matter of law as "the agreement made clear that FTE 'is responsible for ensuring the specified percentage to be debited by BMF retains in the account and will be held responsible for any fees incurred by BMF resulting from a rejected ACH attempt.' Read in tandem, these two provisions suggest that the agreement was aimed at taking money from FTE's account generally, not specifically collecting on receivables.").

156. MCA providers themselves will internally refer to MCAs as loans and will take collateral that far exceeds the scope of the purchased receivables. *See, e.g.*, CapCall, LLC v. Foster, 635 B.R. at 806, 815-16 (Bankr. D. Mont. 2021); *see also What Is Merchant Cash Advance (MCA) or MCA Loan?*, ECAPITAL, https://ecapital.com/financial-term/merchant-cash-advance-mca-or-mca-loan [https://perma.cc/NQT8-Z3Z3] (referring to a "merchant cash advance loan").

157. *See, e.g.*, Rapid Finance MCA, *supra* note 118, at 997 (describing security interest springing automatically upon breach of representation or warranty and covering all inventory and deposit accounts, *inter alia*); Kapitus MCA, *supra* note 119, at 1044 (describing security interest covering all inventory and goods, *inter alia*); Kapitus MCA, *supra* note 119, at (describing security interest in all inventory, goods, accounts, general intangibles, *inter alia*).

it is organized and/operates,"[158] that it has "all necessary permits, authorizations and licenses to own, operate and lease its properties and to conduct the business in which it is presently engaged,"[159] and that the business "is currently in compliance with all federal state and local tax law, ha[s] filed all return[s] and ha[s] paid all taxes due…"[160] These provisions preclude the business from simply ceasing to operate. If an incorporated business simply ceased to operate, it would not have revenue to pay its state franchise taxes, which would result in administrative dissolution by the state.[161] If the business were to cease operating, the warranties of good standing and tax compliance would be violated. In the same MCA, the small business also warrants the maintenance of insurance or of bank accounts.[162] If the small business does not have sufficient revenue, however, it will not be able to maintain insurance policies or a bank account and will be in breach of these warranties.

A violation of any of these warranties would be an Event of Default under the Kapitus MCA,[163] which would mean that the "full uncollected Purchased Amount and any unpaid fees due shall become due and payable in full immediately"[164] and that Kapitus would be able to exercise its self-help right to foreclose on the small business's assets by virtue of its security interest.[165]

Finally, MCAs provide recourse beyond the actual receivables purchased is through general recourse against the small business's owner-guarantor by virtue of the operation of the warranties made within the contract. A personal guaranty by the small business's owner is standard in

158. *Id.* at 1039. The warranties in the MCAs of Rapid Finance and Forward Financing operate similarly to those in the Kapitus MCA. *See* Rapid Finance MCA, *supra* note 118, at 997 (describing representations and warranties, including of maintenance of insurance, licenses, and taxes, and continuation of past business practices); *id.* at 1000 (liquidated damages of amount sold less amount received by MCA provider); Forward Financing MCA, *supra* note 120, at 1021-22 12 (describing representations and warranties including all necessary business licenses and taxes paid, and presumption that if there is a bankruptcy filing or goes out of business that representations were materially untrue), *id.* at 1024 (describing liquidated damages as amount outstanding on MCA).

159. Kapitus MCA, *supra* note 119, at 1038.

160. *Id.*

161. *See* Sandra Feldman, *Business entity administrative dissolution and reinstatement*, WOLTERS KLUWER (Apr. 28, 2024), https://www.wolterskluwer.com/en/expert-insights/the-administrative-dissolution-and-reinstatement-of-business-entities [https://perma.cc/AR8E-WSB4].

162. Kapitus MCA, *supra* note 119, at 1038.

163. *Id.* at 1039-40.

164. *Id.*

165. *Id.* The presence of a security interest in various assets of the small business and the owner ensures that the MCA provider can exercise self-help remedies, depriving the business and the owner of their financial ability to contest the interpretation of the MCA. In many states (although not California) these self-help remedies are bolstered by a confession of judgment.

MCA contracts.[166] The pervasiveness of recourse beyond the actual receivables indicates that MCAs are loans, not true sales.[167]

MCA providers claim that there is only a payment obligation to the extent that there is revenue,[168] so long as no representations, warranties, or covenants have been breached. Accordingly, MCA providers argue the transaction is not a loan as there is not absolute payment obligation. The unavoidable fact, however, is that a business without revenue cannot pay for insurance, licenses, and taxes, and, as noted above, failure to do so violates warranties, accelerating the MCA balance and triggering the guaranty from the owner. The small business will be liable itself in such instances, and there will also be recourse against the owner. Failure to generate revenue ineluctably means a violation of warranties that can only

166. Some MCAs claim that the guaranty is merely one of performance of representations and warranties, not of payment. *See, e.g.*, Kapitus MCA, *supra* note 119, at 1033; *id.* at 1047; Rapid Finance MCA, *supra* note 118, at 1099. In practice, they all operate as guaranties of payment. Consider, for example, the same Kapitus MCA discussed above. Kapitus MCA, *supra* 119, at 1031-52. The Kapitus MCA includes an unconditional guaranty of "all of the representations, warranties, covenants made by" the small business. *Id.* at 1047. It also states that the guarantor "is not making an absolute guaranty of repayment," and "only guaranteeing that they will not take any action or permit the Seller to take any action that is a breach of the Transaction Documents." *Id.* As explained above, however, "the failure of the small business to make payments on the MCA would invariably result in a violation of warranties. Thus, the guaranty will not be triggered by virtue of non-payment *per se*, but by virtue of violation of the warranties that will be violated if the small business cannot or chooses not to pay. And because of the acceleration of the entire obligation upon an Event of Default, upon the breach of a warranty, the guarantor would be liable for the entire outstanding balance on the MCA. Thus, there is for all practical purposes recourse against the guarantor on the obligation of payment under the MCAs; the guaranty is effectively a guaranty of payment. That such a functional guaranty of payment exists is hardly surprising given that Kapitus underwrites its MCAs based in part on the personal credit reports of the small-business owner." Defendant's Motion for Summary Judgment at 1113, Small Bus. Fin. Ass'n v. Hewlett, No. 2:22-cv-08775 (C.D. Cal. Sept. 27, 2023) (expert report of Professor Adam J. Levitin).

167. *See, e.g.*, New Y-Capp v. Arch Cap. Funding LLC, 2022 U.S. Dist. LEXIS 180309, at *13 (S.D.N.Y. Sept. 30, 2022) (noting that "provisions 'worked to ensure while bankruptcy may no longer have been an express default under the revised standard form of MCA Agreement, the guarantor continued to be absolutely liable for repayment in the event of a bankruptcy filing"); LG Funding, LLC v. United Senior Properties of Olathe, LLC, 181 A.D.3d 664, 666 (2d Dep't 2020) ("The agreement provides that in the event United files for bankruptcy or is placed under involuntary filing, the plaintiff would be entitled to enforce the provisions of the personal guaranty"); Lateral Recovery, LLC v. Cap. Mech. Servs. LLC., 632 F. Supp. 3d 402, 456 (S.D.N.Y. 2022) ("And if the merchant declares bankruptcy, the funder still does not take on any risk; the guarantors' obligations . . . are due at the time Merchant admits in inability to pay its debts, or makes a general assignment for the benefit of creditors, *or any proceeding shall be instituted by or against the Merchant seeking to adjudicate it bankrupt*.").

168. *See, e.g.*, Forward Financing MCA, *supra* note 120, at 1021 ("The parties agree that, provided that the Customer has not violated any of the representations, warranties or covenants in this Agreement, it shall not be a breach of this Agreement if Customer generates no further Future Receipts and therefore has no funds to remit the Amount Sold."); *id.* at 1047 ("[I]f Customer's business slows down and Customer's Future Receipts decrease or if Customer closes its business and Customer has not violated any of the representations, warranties and covenants in this Agreement, there shall be no default or breach of this Agreement."); Rapid Finance MCA, *supra* note 118, at 997 ("If Merchant's business slows down and Merchant's Future Receivables decrease or if Merchant closes its business or ceases to process Payment Devices and Merchant has not violated any of the representations, warranties and covenants provided in paragraph 7 below, there shall be no default or breach of this Agreement.").

be performed if there is adequate revenue. In short, the MCA provider frequently does not actually assume the risk of the business failing to generate future receivables because there is recourse against the small business and its owner-guarantor both generally and in the specific assets pledged as collateral that exceed the receivables "sold." These multiple forms of recourse (among other things) mean that MCAs should generally be considered loans.

Finally, the metric of control is one that is specifically coupled in financial accounting standards with those of allocation of upside benefit (excess payments) and downside risk (recourse).[169] The control metric is often useful in other contexts for distinguishing between transfers of actual assets and derivative interests in them, but it also has relevance insofar as one credits MCAs as actually being sales of receivables, rather than receipts. Those receivables are collected by and controlled by the merchant, not the MCA provider. The MCA agreement will likely place some restrictions on their alienation, such as via a negative pledge clause (that is probably not specifically enforceable), but ultimately there is nothing that prevents the merchant from using the receivables collected for its own purposes, until the time for remittance arrives. But notice what would happen if the merchant were to squander away the receivables collected and find itself without the requisite funds to remit: the various recourse provisions in the MCA would place all of the risk of loss on the merchant, not the MCA provider. All three metrics: right to excess payment, recourse, and control, point firmly to MCAs being loans of money, not sales of future receivables.

II. Informational Problems in Small-Business Finance

Lending depends on information. For a lender to be able to price or "underwrite" a loan, the lender needs to be able to gauge the credit risk of the borrower: is the borrower likely to repay the loan in full and on time? Exactly what sort of information a lender will use to determine the answer varies by type of loan, but lenders of all sorts require information, typically about the borrower's past and expected future income and assets and often about the borrower's expenses and liabilities.

169. *See e.g.*, *Statement of Financial Accounting Standards No. 167: Amendments to FASB Interpretation No. 46(R)*, FIN. ACCT. STANDARDS BD. 7 (June 2009), https://fasb.org/page/ShowPdf?path=fas167.pdf&title=FAS%20167%20(as%20issued) [https://perma.cc/E62K-CY4U] (explaining in amended Paragraph 14A that an entity will be deemed to have a controlling interest only if it has the obligation to absorb losses or the right to receive benefits).

A. Informational Asymmetries in Small-business Lending

Obtaining reliable information on income, assets, expenses, and liabilities is frequently one of the major challenges for a lender, and particularly so for small-business lenders. If lenders face an information asymmetry whereby borrowers know more about their likelihood of repayment than lenders, then lenders are likely to respond by rationing credit, meaning that the supply of credit will not rise to meet the demand, even at higher prices, or by not lending at all.[170] In consumer markets, an infrastructure of credit reporting and credit scoring has developed to address the need for information. Small-business lending, however, is beset by a set of informational problems that result an information asymmetry between borrowers and lenders.[171]

First, credit reporting on small businesses is much less comprehensive and standardized in its coverage than for consumers. There simply will not be a credit report available for many businesses.[172] Moreover, in contrast to consumer reporting, where three large national consumer reporting agencies have market-wide coverage, credit information on businesses is fragmented among data vendors, such that lenders have to rely on multiple data providers whose information may not always be comparable.[173]

Second, small businesses do not themselves always generate reliable financial information. They often do not have audited financial statements, particularly if they are very small enterprises. Moreover, if the small business has been set up as a pass-through entity for tax purposes (sole proprietorships, partnerships, LLCs, and S-corporations), then it will not have its own tax returns, which could otherwise serve as a source of more reliable information for a prospective lender. Microenterprises will often lack a business bank account, so their bank records cannot be used to establish revenues and expenses.[174]

Third, small businesses tend to be much younger than larger businesses—growth typically happens over time. Younger businesses may

170. *See generally* George Akerlof, *The Market for 'Lemons': Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970) (modeling market failure resulting from information asymmetry); Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 AM. ECON. REV. 393 (1981) (modeling asymmetric information resulting in credit rationing).

171. *See The Future of Small-Business Lending*, MOODY'S (Nov. 1, 2016) ("Lenders commonly complain that small business information does not provide sufficient detail to make a lending decision.").

172. Gary Stockton, *From No Business Credit to Funding Ready: How to Overcome New Business Funding Roadblocks*, EXPERIAN (Mar. 26, 2025), https://www.experian.com/blogs/small-business-matters/2025/03/26/from-no-business-credit-to-funding-ready-how-to-overcome-new-business-funding-roadblocks [https://perma.cc/A59A-ZT6X].

173. Arun & Page, *supra* note 52.

174. If the small business uses a nonbank payment processor, such as PayPal and Square, or an online sales platforms, such as Amazon, then those processors or platforms, all of which engage in small-business lending, will have a reliable source of data that is not available to other small-business lenders.

not have an established credit and performance history, making it difficult for lenders to evaluate their future likelihood of repayment. In particular, lenders usually want at least two, if not three, years of financial statements or tax filings, and this is simply not available for many small businesses.[175]

Fourth, the financial situation of many small businesses is completely intertwined with that of their owners. 88% of small businesses with employees relied on their owner's personal credit score to obtain financing,[176] and 59% of employer firms with debt used a personal guaranty to obtain credit.[177] The owner is a potential source of financial strength and weakness for the business: the owner can contribute capital or withdraw it from the business based on the owner's personal financial situation. This means that the financial situation of the owner is essential to lending, especially when there is a personal guaranty from the owner. It also means that any change in the owner's personal life—death, divorce, disability, etc.—affects the business's credit profile. The owner-operator model also means that there is effectively key-person risk for the small business of a type that does not exist for larger enterprises with a division between owners and employees. While a lender can obtain information about the owner-operator's finances, the interaction with those of the business is not always apparent.

A. Difficulties Modeling Small-Business Underwriting

Not only do lenders lack reliable data, but it is also difficult for lenders to model the expected performance of a small-business loan because of the heterogeneity of small-business borrowers relative to consumer borrowers in terms of risks and cash flows. This heterogeneity means that it is difficult for lenders to model their expected economic performance because reliable modeling requires large *n*s—large numbers of similar borrowers. With small-businesses lending, however, the *n*s are too small and unique.

For example, a dentist in Des Moines, an app designer in Austin, a hardware store in Honolulu, a pool cleaning company in Pittsburgh, an ice cream store in Miami, a ski shop in Vail, a small plaintiffs' law firm in Indianapolis, and a jewelry store in Jersey City have little in common in terms of their risk profiles or cash flows.

175. Arun & Page, *supra* note 52 ("For small-business lending above the branch banking level, most bank lenders request three years of financial statements, collected either via unaudited financial reports from the prospective borrower or in the form of tax returns for the business."). *See also* Calla Norman, *Top 6 Obstacles to Getting Small-business loans - and How to Overcome Them*, HONEYCOMB CREDIT, https://www.honeycombcredit.com/post/top-6-obstacles-to-getting-small-business-loans-and-how-to-overcome-them [https://perma.cc/7SSN-8NVJ] ("Many traditional financiers such as banks or small-business loans want you to have been in business for at least two years before applying. This makes sense because it allows you to prove to them that you've been able to successfully and sustainably run your business.").

176. *2020 Small-business credit Survey: Report on Employer Firms*, *supra* note 56, at 8.

177. *Id.* at 7.

These businesses are all likely to have only a single location or at most a few locations in a metropolitan area, meaning that they do not have geographic diversification protecting their business. The Des Moines dentist is exposed to the economic conditions (and water fluoridation policy) of Des Moines in a way that the app designer in Austin is not, and vice-versa. The ski shop's business depends on the weather in its location: no snow, no sales. And some businesses are simply more likely to be successful depending on geography (*e.g.*, pool equipment in Phoenix, Arizona, vs. in Fairbanks, Alaska).

These businesses' cash flows are heterogenous too. Some have highly seasonal income, such as the pool cleaning company, ice cream store, ski shop, the accounting firm (tax season), and perhaps the jewelry store (holiday sales). The plaintiffs' firm gets paid if and when it collects on a judgment, the timing of which is irregular and hard to predict. The dentist's revenue depends on the timing of insurance payments. The heterogeneity among these businesses means that an economic model that is predictive of the dentist's business might not work for the jeweler and so on.

The nature of the risks faced by the businesses also varies. The jeweler has a theft risk that the app designer does not have, the pool cleaning company faces a different regulatory environment than the ski shop. This sort of variation in business risks has no counterpart in consumer lending.

B. Fintech Lending as a Response to Informational Problems

The informational problems plaguing small-business finance make it more difficult for small businesses to obtain credit, much less quickly. This is particularly true for newer businesses and microenterprises that are financially hard to distinguish from their owner(s). Indeed, SBA Section 7(a) loans are effectively unavailable for businesses with less than three years of operational history.[178]

As Professor Ronald Mann has shown, collateral is a common device for overcoming informational asymmetries, as the lender can lend against the value of the collateral, rather than harder-to-predict cash flows.[179] Asset-based lenders do not have the same modeling problem because their lending amount and pricing derive from collateral value and non-borrower factors.

Collateral-based borrowing is not always an available solution for small businesses, however. Small businesses, particularly new ones, might lack readily marketable collateral beyond their receivables, especially if they are a service-based business. Alternatively, what assets they have might already be secured by purchase-money financing, making them unattractive as collateral for general operational financing. Thus, collateral

178. *See* Arun & Page, *supra* note 52.
179. Mann, *supra* note 37, at 9-10.

is only a partial solution to the informational asymmetry problem in small-business lending. A subset of small-business borrowers cannot use collateral to overcome informational problems.

Over the past decade, the small-business lending market has changed. Banks have pulled back in their small-business lending after the 2008 financial crisis, but finance companies and fintechs—nonbank lenders that lack a brick-and-mortar presence—have more than offset the decline in bank lending.[180] In particular, fintechs offer rapid financing to small businesses with limited or poor credit histories.

The fintech lenders that have emerged are of two types. One type is the straight fintech, a company that provides only financing. These companies, such as Rapid Finance and Kapitus, are not household names. The other type is a platform fintech—an online platform that offers financing for the merchants who operate on the platform. These are well-known companies like Amazon, DoorDash, MindBody, PayPal, Shopify, Square, and WalMart that have pre-existing bases of small-business customers that use the platform to sell goods (Amazon, Shopify, WalMart), sell services (DoorDash, MindBody), or process payments (PayPal, Square). Some platform fintechs sometimes handle the entire financing in-house or through an affiliate.[181] In other cases, however, the financing is provided by a third-party straight fintech partner. For example, the financings offered via Amazon and Doordash are actually operated by an unaffiliated fintech called Parafin.[182]

The business model of straight fintech lenders is different than that of platform fintech lenders. Straight fintech lenders have been able to serve small businesses with limited or poor credit histories because they underwrite small businesses based not on the credit profile of the *business*, but primarily on the credit profile of the *owner*. Consumer credit underwriting is generally automated and fast, relying heavily on credit scores,[183] and if the loan is personally guaranteed by the business's owner, then underwriting based on the owner's credit risk will capture a good part of the risk involved with the loan. Straight fintech small-business lenders thus solve the informational problems in small-business lending by ignoring the credit risk of the informationally deficient small business and instead concentrating on the credit risk of the informationally robust and

180. Manasa Gopal & Philipp Schnabl, *The Rise of Finance Companies and FinTech Lenders in Small-Business Lending*, 35 REV. FIN. STUDIES 4859, 4859 (2022) (documenting increase in lending by finance companies and fintech lenders to small businesses after 2008 financial crisis, offsetting the decline in bank lending).

181. *See, e.g.*, Shopify, Annual Report (Form 40-F) 9 (Dec. 31, 2023).

182. *See* Sean Murray, *How the Amazon/Parafin Merchant Cash Advance Deal Came to Be*, DEBANKED (Nov. 2, 2022), https://debanked.com/2022/11/how-the-amazon-parafin-merchant-cash-advance-deal-came-to-be [https://perma.cc/84WT-TD8V].

183. *See, e.g.*, Elevate Credit, Inc. Annual Report (Form 10-K) 8 (Feb. 2, 2019) ("As a result of our proprietary technology and risk analytics, approximately 94% of loan applications are automatically decisioned in seconds with no manual review required.").

readily modellable consumer owner. The use of a personal guaranty to overcome informational problems is akin to the use of collateral to solve informational problems that Mann identified.[184] In this regard, straight fintechs have not really overcome the informational problems about the business entity borrower. Instead, they have substituted in a consumer borrower—the owner—and underwritten the loan at least in part on the owner's financial characteristics, but the financing is not subject to consumer protections.[185]

In contrast, platform fintechs often do not take a personal guaranty.[186] Instead, they use their visibility into the transactions of the merchants who use their platforms to overcome the informational challenge in small-business lending. For example, Amazon knows of every sale an Amazon seller undertakes on its platform. Because Amazon knows the seller's sales history, it has the data to be able to predict the time it would take to repay an advance if Amazon were to deduct a fixed percentage of the sales revenue from what it remits to the merchant. Amazon does not need to rely on the representations of the seller or those of a third party, like a credit bureau, for such information.

The platform's visibility into the business's sales goes a substantial way to addressing the informational problems in small business, but it is not the platform's only advantage. The platform also has a leg up over other lenders when it comes to collections. An Amazon seller is not paid directly by a consumer who purchases goods on Amazon. Instead, the consumer pays Amazon, which then pays the seller by crediting the seller's bank account. This gives Amazon the ability to deduct funds owed to it by the seller off the top, without ever having to go to court or track down the seller's assets. Moreover, Amazon's ability to set off the advance against the business's future revenue ensures that Amazon will have first dibs on the funds, such that it does not have to worry about competing creditors.

This model works the same regardless of whether the platform handles the entire financing itself or partners with a straight fintech. If the platform partners with a fintech, as Amazon, DoorDash, and MindBody do, for example, the platform acts as the lead generator and gives the fintech access to the merchant's sales data. The platform also handles the collections part of the servicing, meaning that it deducts the payments on the financing from the merchant's sales revenue and remits those payments

184. Mann, *supra* note 37, at 26-30.

185. Community banks could, in theory, take the same approach, but they would lose their comparative advantage of hands-on underwriting and local economic knowledge. The very reasons why community banks do not focus on consumer lending discourage them from focusing on small-business owners' financings as a substitute for the small business's finances. *See supra* section I.B.3.a. Large banks do already engage in automated consumer underwriting, but they have generally avoided high-risk lending in part because of the reputational concerns.

186. *See supra* note 33.

to the fintech. The fintech does the underwriting, funds the financing, and provides the servicing interface with the merchant.

Although fintechs have various ways of surmounting the informational problems in small-business lending, they are less than optimal. Platform fintech financing is available only to small businesses that use the platform and is inherently non-competitive, while straight fintech lending simply sidesteps the small-business informational problem by focusing on the finances of the owner. As a result, informational problems persist as a barrier to lending.

Additionally, both types of fintech lending, straight and platform, often come at a high cost and with onerous payment terms. Some of this cost merely reflects the risks posed by lending to less creditworthy businesses. But some is monopolistic price-making that is enabled by borrowers' high search costs.

The difficulty small businesses (particularly younger and smaller businesses) have in obtaining credit means that they have less market power when negotiating terms of credit and often face the very real prospect that if they decline an offer of credit, they will not be able to readily obtain another offer.[187] Therefore, when a small business does get a credit offer, it is likely to accept, rather than engage in comparison shopping and risk the expiration of the current offer. This is particularly true if the small business has an urgent need for financing and does not know when, if ever, an alternative offer will come through. The low likelihood of getting another offer and the risk of losing the current one means that search costs are high, so borrowers are unlikely to search further when they get an offer. If borrowers do not search once an offer is made, lenders are likely to charge the monopoly price, as they face no competition at that point.

This situation is essentially the one described first by economist Peter Diamond regarding search costs. In Diamond's model, if search costs are so high that consumers do not search, then prices will equilibrate at the monopoly price with each firm acting as a complete monopolist.[188] As

187. *See supra* text accompanying notes 14-15 (noting high rate of complete or partial loan application denial as well as borrowers that do not apply for loans because they anticipate rejection).

188. *See*, *e.g.*, Peter A. Diamond, *A Model of Price Adjustment*, 3 J. ECON. THEORY 156, 166-68 (1971) (describing the "Diamond Paradox" that in a market for a homogeneous good with high search costs and sequential searches, then prices will equilibrate at the monopoly price); Steve Salop & Joseph E. Stiglitz, *Bargains and Ripoffs: A Model of Monopolistically Competitive Price Dispersion*, 44 REV. ECON. STUD. 493, 493-94, 503 (1977) (nothing that if "consumers prefer not to search . . . a firm could raise its price, lose no customers and increase its profits"); Alan Schwartz & Louis L. Wilde, *Intervening In Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630, 643-44 (1979) ("[I]f consumers learn a store's price only by visiting it, a consumer will not switch to the single price-cutting firm because the probability of finding the one firm charging less than [the monopoly price], when many firms exist, is too low to make switching an optimal shopping strategy. Thus the market price remains at [the

economists Steve Salop and Joseph Stiglitz explain in one of a number of papers in which they extend Diamond's insight: "When search is costly, individuals must decide whether to enter the market . . . . Under these circumstances, each firm is obviously a pure monopolist; once a consumer arrives at a store, he is perfectly captive, since he may not search again."[189] And given that the "cost" of small-business financing, particularly in the case of MCAs, is often hidden in contract terms, rather than express price terms, search costs are inherently high in the small-business financing market.[190]

This situational monopoly[191] problem persists with platform fintech small-business lending. Irrespective of the platform's market power in general, the platform has monopoly power in the market for financing the small businesses that use its services precisely because it is the only entity that can solve the informational problem without a personal guaranty that some small-business owners are loathe to give. Moreover, the platform's ability to engage in setoff is a significant deterrent for any other lender because the platform will be able to jump ahead of it if there is a grab race for the business's limited assets.

In consumer credit markets concerns about lending to excessively risky borrowers and about monopolistic price making are both addressed through usury laws, which limit the price of credit. Usury laws have the effect of rationing credit; riskier borrowers are shut out of the market, but this is often seen as a positive, paternalistic intervention, ensuring that borrowers do not find themselves mired in unsustainable debts, which can have negative externalities. Usury laws also ensure that even if a lender has market power it cannot exploit such power to gouge borrowers, regardless of their riskiness. As the next Part discusses, however, usury laws—and consumer credit protection laws in general—rarely apply to small-business lending.

III. The Lack of Regulation of Small-Business Finance

Because of the market failure caused by the information problems in small-business lending, competition provides only limited protection to small businesses against overreaching and abusive lending terms and practices. In other markets, such as consumer lending, market failures are

monopoly price]."); Steve Salop & Joseph E. Stiglitz, *The Theory of Sales: A Simple Model of Equilibrium Price Dispersion with Identical Agents,* 72 AM. ECON. REV. 1121, 1126 (1982).

189. Steve Salop & Joseph E. Stiglitz, *The Theory of Sales: A Simple Model of Equilibrium Price Dispersion with Identical Agents,* 72 AM. ECON. REV. 1121, 1126 (1982).

190. *See* Schwartz & Wilde, supra note 188, at 659-62 ("It is more costly for consumers to search for terms than for prices or some aspects of quality; if too few price searchers exist to generate a competitive or almost competitive price structure, too few term searchers may exist to generate a nonmonopolistic term structure.").

191. To emphasize, there is not a literal monopoly with only a single seller, but rather a situation in which firms price as if they were monopolists.

routinely addressed with regulatory interventions. Such interventions, however, are lacking in the small-business lending market, meaning that small businesses have neither the protection of competition nor of regulation. This Part contrasts the regulation of consumer lending with commercial lending and before turning to an examination of the types of abusive practices that have flourished in the small-business lending market.

A. Regulation of Consumer vs. Commercial Lending

Consumer lending markets are heavily regulated at both federal and state levels.[192] In contrast, there is little general regulation of business lending beyond private law—contracts and torts. For example, the federal Truth in Lending Act, which requires standardized credit cost disclosures, does not apply to business credit.[193] Likewise, the federal Consumer Financial Protection Act's prohibition on unfair, deceptive, and abusive acts in lending does not cover business lending,[194] nor does the federal Electronic Fund Transfer Act's prohibition on conditioning credit upon repayment by preauthorized electronic fund transfers.[195] Similarly, the federal Fair Credit Reporting Act, governing credit reporting,[196] and Fair Debt Collection Practices Act, governing debt collection,[197] do not apply to business credit.[198] Additionally, the FTC's Credit Practices Rule's prohibitions on assignments of wages, confessions of judgment, and taking non-purchase money security interests in household goods applies only to loans "to consumers,"[199] so personal guarantors of small-business loans are not protected by the rule.

Instead, there are only two generally applicable federal regulations of lending that apply to commercial lending. First, the Equal Credit Opportunity Act, which prohibits discrimination against protected classes in lending, applies to all lending, consumer and commercial.[200] Second, the

192. *See generally* ADAM J. LEVITIN, CONSUMER FINANCE: MARKETS AND REGULATION (2d ed. 2022).

193. 15 U.S.C. § 1603(1) (2018). There is an exception for certain credit cards issued to employees of a business. 15 U.S.C. § 1645.

194. 12 U.S.C. § 5481(5)(A) (2018).

195. 15 U.S.C. §§ 1693a(2), 1693a(6), 1693k(1) (2018).

196. 15 U.S.C. §§ 1681 *et seq*. (2018).

197. 15 U.S.C. §§ 1692 *et seq*. (2018).

198. *See* 15 U.S.C. § 1681a(c)-(d) (2018) (defining a "consumer report" to relate to the creditworthiness of an individual); 15 U.S.C. § 1692a(5) (2018) (defining "debt" for FDCPA purposes to be limited to the obligation of a consumer to pay money out of a transaction primarily for personal, family, or household purposes.).

199. 16 C.F.R. §§ 444.1(d) (2024) (defining "consumer), 444.2(a) (2024) (defining unfair credit practices).

200. 15 U.S.C. §§ 1691 *et seq.* (2018). Federal law also requires the collection of small-business lending data to facilitate enforcement of the discriminatory lending prohibition. 15 U.S.C. § 1691c-2 (2018). The compliance deadline for the implementing rule is in 2025 or 2026, depending

Federal Trade Commission Act's prohibition on unfair and deceptive acts and practices applies to commercial as well as consumer lending, but excludes lending by banks,[201] and has rarely been invoked by the FTC for business loans.[202]

State law also imposes substantial regulations on consumer lending. State law generally requires lenders to be licensed.[203] It also limits the cost of credit with usury limits,[204] and frequently regulates other loan terms.[205] State law also often imposes disclosure requirements that generally incorporate those of the Truth in Lending Act.[206]

State usury laws often do not apply to business lending,[207] however. Even when they do, they do not apply to most lending by banks.[208] Likewise, state lender licensing laws frequently do not apply to business

on institution size. *See Small-Business Lending Rulemaking*, CONSUMER FIN. PROT. BUREAU (June 25, 2024), https://www.consumerfinance.gov/1071-rule [https://perma.cc/JQ37-PDBR].

201. 15 U.S.C. § 45(a)(1)-(2) (2018).

202. I have been able to identify only two instances in which the FTC has invoked the FTC Act's prohibition on unfair and deceptive practices regarding a business lender. *See* Complaint, FTC v. Yellowstone Capital LLC, No. 20-cv-06023 (S.D.N.Y. Aug. 3, 2020); Complaint, FTC v. RCG Advances, LLC, No. 20-cv-04432 (S.D.N.Y. June 10, 2020).

203. *See, e.g.*, 17 ILL. COMP. STAT. 670/21 (2021) (exempting entities making solely business loans from state lender licensing requirement); N.Y. BANKING L. § 340 (Consol. 2024) (requiring license for making loans of $25,000 or less to individuals for personal, family, household or investment purposes and for loans of $50,000 or less to for businesses); 7 PA. CONS. STAT. §§ 6203 (2024) (requiring license for making loans of $25,000 or less); R.I. GEN. LAWS § 19-14.1-10(b)(1) (2024) (exempting business loans from regulation, including licensing).

204. Adam J. Levitin, *The New Usury: The Ability-to-Repay Revolution in Consumer Finance*, 92 GEO. WASH. L. REV. 425, 438 (2024).

205. *See, e.g.*, WASH. REV. CODE § 31.04.125(1)-(2) (2024) (restricting method of calculating interest); *id.* § 31.04.125(3) (restricting credit life and disability insurance with loans); R.I. GEN. LAWS § 19-14.1-2(b) (regulating amortization of loans for purposes of rebates on finance charges).

206. *See, e.g.*, MINN. STAT § 47.59(12) (2024) (incorporating TILA requirements in state law).

207. *See, e.g.*, 41 PA. CONS. STAT § 201(b)(3) (2024) (exempting all business loans from the usury law); 17 ILL. COMP. STAT. § 205/4(a), (c) (2022) (exempting all loans to corporations or to businesses from the usury law). In some states, usury laws do not apply to loans above a specified size. *See, e.g.*, N.J. REV. STAT. § 31:1-1(e)(1) (2024) (exempting loans above $50,000 that are not secured by a first lien on a property with six or fewer residences); N.Y. GEN. OBLIG. L. § 5-501(6)(a)-(b) (Consol. 2024) (exempting loans of $250,000 and not secured by a 1-2 family residential property or of $2.5 million or more from usury laws); VA. CODE ANN. § 6.2-317(B) (2024) (exempting business loans of over $5,000 from the usury statute). As business loans tend to be larger than consumer loans, these exemptions apply primarily to business loans. In other states corporate entities cannot raise a civil usury as a defense. *See, e.g.*, N.Y. GEN. OBLIG. L. § 5-521(1) (Consol. 2024).

208. *See* Levitin, *Rent-a-Bank*, *supra* note 72, at 349-53 (explaining application of the National Bank Act, 12 U.S.C. § 85, and Federal Deposit Insurance Act, 12 U.S.C. § 1831d, to effectively exempt most bank lending from usury laws).

lenders[209] or banks.[210] As a result, loans made by banks are outside the ambit of the most significant types of state credit regulation. Even if some state's law would apply, however, choice of law provisions in lending contracts can often be used to ensure the application of a favorable state's law.[211]

Additionally, state lending regulations apply only to loans or credit. Accordingly, MCAs are generally outside the scope of state lending regulations because the transactions purport to be sales of future receivables, rather than loans of money. If MCAs' formal structure is credited, then neither usury laws nor licensing requirements would apply to MCAs and their providers. Georgia law even expressly provides that for the purposes of its usury law, "a provider's characterization of an accounts receivable purchase transaction as a purchase shall be conclusive that the accounts receivable purchase transaction is not a loan or a transaction for the use, forbearance, or detention of money."[212] In other words, under Georgia law, if a transaction says it is an accounts receivable purchase, then usury laws do not apply, irrespective of the actual substance of the transaction.

Although business lending largely exists outside of the scope of state law, in recent years a number of states have expanded their regulatory regimes to cover small-business financing. As of the date of this Article, seven states have special regulatory regimes for small-business financing.

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209. *See, e.g.*, 17 ILL. COMP. STAT. § 670/21 (2021) (exempting business lender). In many other states, there is not express exemption for business lenders; instead, the licensing requirement is only for consumer lenders. *See, e.g.*, MD. CODE ANN., FIN. INST. § 11-301(b)(5) (2024). Many states treat smaller loans (often below $10,000) as consumer loans, but therefore exempt lenders that only lend over that limit from licensing requirements. *See, e.g.*, ARIZ. REV. STAT. § 6-602(A)(3) (2024) (exempting loans of over $10,000 from consumer lender licensing).

210. *See, e.g.*, ALASKA STAT. § 06.20.010(b) (2024) (exempting banks and credit unions from licensure requirement).

211. William B. Emmal, *Evading Prohibitions on Usury through Choice of Law*, *in* 9 THE TRANSACTIONAL LAWYER 6 (Aug. 2019); Christopher Basile, *Criminal Usury and Its Impact on New York Business Transactions*, 36 TOURO L. REV. 409, 421 (2020).

212. GA. CODE ANN. § 10-1-393.18(c) (2024).

California,[213] Connecticut,[214] Florida,[215] Georgia,[216] New York,[217] Utah,[218] and Virginia[219] all have credit cost disclosure requirements for small-business lending, and California,[220] Connecticut,[221] Utah,[222] and Virginia[223] also requires licensure or registration of commercial lenders. Notably, the threshold for what constitutes a regulated small-business financing varies considerably among these states, with New York regulating transactions up to $2.5 million, while next door Connecticut regulates only transactions up to $250,000.

B. Abuses That Have Arisen in the Absence of Regulation

In the absence of competition and regulation, a number of predatory lending practices have thrived in small-business lending markets: misleading price disclosures, supracompetitive pricing, and abusive collection practices. This section reviews each one of these problems in turn.

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213. CAL. FIN. CODE §§ 22800(e), 22800(m), 22801, 22802(a) (West 2024) (requiring standard credit cost disclosures for nonbank commercial financings of between $5,000 and $500,000).

214. CONN. GEN. STAT. §§ 36a-861 to 36a-872 (2024) (requiring standardized credit cost disclosures for non-bank, non-purchase money, non-mortgage commercial financings of under $250,000).

215. FLA. STAT. ANN. §§ 559.9612-9613 (2024) (requiring standardized credit cost disclosures for nonbank financings of $500,000 or less, but exempting banks, bank subsidiaries, and licensed nonbank money transmitters, such as PayPal and Square).

216. GA. CODE ANN. § 10-1-393.18 (2024) (requiring standardized credit cost disclosures for nonbank financings of $500,000 or less, but exempting banks, bank subsidiaries, and licensed nonbank money transmitters, such as PayPal and Square).

217. N.Y. FIN. SERV. L. §§ 801-812 (Consol. 2024); N.Y. COMP. CODES R. & REGS., tit. 23 § 600 (2024) (requiring standardized credit cost disclosures for nonbank financings of $2.5 million or less, but exempting banks).

218. UTAH CODE ANN. §§ 7-27-102, 7-27-202 (West 2024) (requiring standardized credit cost disclosures for non-purchase money, non-mortgage commercial financings of $1 million or less, but exempting banks, bank subsidiaries, and licensed nonbank money transmitters, such as PayPal and Square).

219. VA. CODE § 6.2-2231 (2024); 10 VA. ADMIN. CODE §§ 5-240-10 to 5-240-40 (2024) (requiring standardized credit cost disclosures for nonbank financings of $500,000 or less, but exempting all regulated financial institutions).

220. CAL. FIN. CODE §§ 22009, 22100 (2024) (requiring licensure of any person engaged in making commercial loans).

221. CONN. GEN. STAT. §§ 36a-861 to 36a-872 (2024) (requiring registration of non-bank providers of non-purchase money, non-mortgage commercial financings of under $250,000).

222. UTAH CODE ANN. § 7-27-201 (West 2024) (requiring registration for providers of non-purchase money, non-mortgage commercial financings of $1 million or less, but exempting banks, bank subsidiaries, and licensed nonbank money transmitters, such as PayPal and Square).

223. VA. CODE §§ 6.2-2228-2230 (requiring registration for providers of non-purchase money, non-mortgage commercial financings of $500,000 or less, but exempting all regulated financial institutions).

1. Misleading Price Disclosures

The price theory of demand is the basic building block of all economics. It holds that the level of demand for a product relates to the product's price. The price theory of demand is premised on the availability of adequate and accurate price information. If a borrower does not know or understand the price of credit, he may make decisions regarding whether to borrow and on what terms that are inconsistent with his actual preferences. In other words, if the borrower lacks sufficient information, the borrower may misconsume, which is bad for the borrower's welfare and miscalibrates the aggregate supply and demand in the economy. Additionally, misleading price disclosure raises search costs for borrowers and therefore discourages search, contributing to monopolistic pricing under the Diamond/Salop-Stiglitz model.[224]

a. TILA Credit Cost Disclosure for Consumer Credit

The importance of adequate information for borrowing decisions is recognized by Truth in Lending Act (TILA), the centerpiece of American *consumer* credit regulation. TILA's statutory declaration of purpose explains:

> The informed use of credit results from an awareness of the cost thereof by consumers. It is the purpose of this subchapter to assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him and avoid the uninformed use of credit. . . .[225]

TILA requires a variety of disclosures about the material terms of extensions of credit.[226] The particular requirements vary by product, but for all extensions of credit TILA requires the disclosure of the cost of credit using a pair of standard metrics, the "finance charge" and the "annual percentage rate" (APR), which are designed to facilitate comparison shopping by allowing an apples-to-apples comparison of cost, at least for similarly structured products.[227] Facilitating such apples-to-apples comparisons helps reduce search costs for borrowers.

All extensions of consumer credit must disclose the finance charge or (for open-end credit) when it will be imposed.[228] The financing charge is an aggregate, all-in dollar price for credit. As defined in the Code of Federal Regulations provision implementing TILA, the finance charge is:

224. *See supra* Section II.C (describing the Diamond and Salop-Stiglitz models of search costs).
225. 15 U.S.C. § 1601(a) (2018).
226. 15 U.S.C. § 1631(a) (2018).
227. 15 U.S.C. § 1637(a) (2018).
228. 15 U.S.C. §§ 1632(a); 1637(a) (open-end credit); 1638(a)(3) (close-end credit) (2018).

> the cost of consumer credit as a dollar amount. It includes any charge payable directly or indirectly by the consumer and imposed directly or indirectly by the creditor as an incident to or a condition of the extension of credit. It does not include any charge of a type payable in a comparable cash transaction.[229]

Interest is always a finance charge,[230] but the finance charge can also include certain fees. The requirement of disclosure of the finance charge means that consumers can readily see the total cost of financing in a dollar amount and compare it with other financing offers.[231]

The all-in nature of the finance change avoids potentially misleading "partitioned" pricing, where the lender charges multiple fees or rates that are individually smaller than the all-in cost. In such a situation, to get the all-in price, the consumer must accurately perform a mathematical calculation. If the consumer does not do this—and consumers are often loathe to perform mathematics and are not always very good even at simple addition[232]—the consumer might mistakenly focus on some of the more salient fees or rates and as a result misperceive the total price.[233] Requiring disclosure of the all-in finance charge avoids the risk of consumer miscalculation or misestimation.

The APR is a standard unit price for a finance charge. Specifically, the APR is "a measure of the cost of credit, expressed as a yearly rate, that relates the amount and timing of value received by the consumer to the amount and timing of payments made."[234] In other words, the APR is measuring the cost of a loan *relative to the amount of money loaned and for how long*. Put another way, the APR is measuring the relationship between three variables: (1) the finance charge, (2) the amount financed, and (3) the length of the financing.[235] Although the APR is expressed as a

229. 12 C.F.R. § 1026.4(a) (2018); *see also* 15 U.S.C. § 1605(a) (2018).

230. 15 U.S.C. § 1605(a)(1) (2018).

231. The finance charge does not indicate the timing of payments; a payment due in 30 years is treated the same as one due immediately in terms of calculating the finance charge.

232. *See Adult Numeracy in the United States*, *NCES 2020-25*, INST. OF EDUC. SCIENCES (Sept. 2020), https://nces.ed.gov/pubs2020/2020025.pdf [https://perma.cc/Y9W6-9SKB] (reporting that 30% of U.S. adults lack "sufficient numeracy skills to make calculations with whole numbers and percentages, estimate numbers or quantity, and interpret simple statistics in text or tables—numeracy skills at level 2 or above" in English in Program for the International Assessment of Adult Competencies, the standard test of numeracy).

233. Critically, this problem is not a behavioral economics issue of hyperbolic discounting of contingent fees like late fees or overlimit fees, because they are not included in the finance charge. *See* 12 C.F.R. § 1026.4(c)(2) (2024) (excluding charges for actual, unanticipated late payment or exceeding a credit limit from the finance charge).

234. 12 C.F.R. § 1026.22(a) (2024). *See also* 15 U.S.C. § 1606(a) (2018) (defining annual percentage rate (APR)).

235. The calculation of the APR under TILA varies depending on the type of extension of credit, which does limit its usefulness for comparisons across different types of credit products. The APR is calculated differently for open-end credit (that is, credit without a finite due date, such as lines of credit) and for closed-end credit (that is credit with a finite due date, such as a home mortgage). 15 U.S.C. § 1606(a)(1)-(2) (2018).

percentage rate, it is not (usually) the interest rate, as it reflects all finance charges, not just interest. Critically, the APR is not the "price" of credit; borrowers do not pay the APR. Instead, APR is a standardized metric of how expensive it would be to carry the financing for a full year.

The APR facilitates the credit cost comparison that Congress believed was so vital by providing a common denominator for expressing in annualized terms the all-in costs of credit (the total finance charges) relative to the amount of funds loaned and for how long the money is loaned. As the Consumer Financial Protection Bureau has explained, "The APR, or annual percentage rate, is the standard way to compare how much loans cost. It lets you compare the cost of loan products on an 'apples-to-apples' basis."[236] By standardizing the relationship among these three variables into a single metric, the APR enables consumers to readily compare the different financing options.

For open-end credit, the APR is simply the periodic interest rate multiplied by the number of periods in a year. 12 C.F.R. § 1026.14(b) (2024). Other finance charges, like annual fees, are not included in the APR for open-end credit, nor is there consideration of the amount borrowed, length of borrowing, or payment stream. The use of "spurious" open-end credit—that is transactions that purport to be open-end credit and thereby avoid disclosure of non-interest finance charges in the APR—even though the products actually function as closed-end credit has been a consistent policy concern in APR disclosures. *See* NAT'L CONS. L. CENTER, TRUTH IN LENDING, § 6.2.3 (11th ed. 2023).

For closed-end credit, the APR is "a measure of the cost of credit, expressed as a yearly rate, that relates the amount and timing of value received by the consumer to the amount and timing of payments made." 12 C.F.R. § 1026.22(a)(1) (2024). Calculation of the APR for closed-end credit accounts for all finance charges, including both periodic rates and fees.

For short-term, single payment products, like most payday loans, the APR calculation is straightforward enough, multiplying the number of periods in a year by the difference of the quotient of the payment over advanced minus one. 2 C.F.R. pt. 1026 app. J. § (c)(5) (2024). But for installment loans, the calculation of the closed-end APR is mathematically complex, and even more so if it has compounded interest. 12 C.F.R. § 1026, App. J (mathematical calculation of the APR for closed-end credit). This is because the amount of the loan outstanding is periodically changing with the installment payments and the compounding, as the APR must reflect the finance charges relative to the amount outstanding. Calculation of the APR for installment loans is often performed using a free on-line tool provided by the federal government, because the calculations in the lengthy mathematical appendix to the relevant part of the Code of Federal Regulations are unwieldly. 12 C.F.R. § 1026.22(b)(2) (2024) (authorizing use of computational tools to calculate the APR); *see also FFIEC Federal Disclosure Computational Tools*, FED. FIN. INSTS. EXAMINATION COUNCIL, https://www.ffiec.gov/examtools/FFIEC-Calculators/APR/#/accountdata [https://perma.cc/4MRM-2VWF] (displaying a free online APR calculator provided by the Federal Financial Institutions Examination Council). A distinct calculation of the APR is used for purposes of the Military Lending Act, 10 U.S.C. § 987(i)(2) (2018); 32 C.F.R. § 232.4(c)-(d) (2024).

Because the APR is an annualized percentage rate, its calculation necessarily includes an annualization factor. The annualization is what makes the APR a useful tool for comparing the costs of similar types of financings. Without the annualization, costs would be presented on an apples-to-oranges basis because of different lengths of credit extensions, frustrating the comparison shopping that is necessary for efficient markets and borrower protection.

236. *What Is an APR on a Payday Loan and How Should I Use It?*, CFPB (Jan. 17, 2022), https://www.consumerfinance.gov/ask-cfpb/my-payday-lender-said-my-loan-would-cost-15-percent-but-my-loan-documents-say-the-annual-percentage-rate-apr-is-almost-400-percent-what-is-an-apr-on-a-payday-loan-and-how-should-i-use-it-en-1625 [https://perma.cc/MVZ9-UH4Z].

b. Misleading Small-Business Credit Cost Disclosure

Consumer borrowers benefit from TILA's standardized credit cost disclosures, but there is no such requirement for business credit under federal law, and only a handful of states have credit cost disclosure requirements for small-business credit.[237] This situation facilitates some of the same abuses that TILA was adopted to address in the consumer credit market.

Although there are generally no disclosure requirements for small-business credit, this does not mean that there is no credit cost disclosure. As a matter of contract law, small-business lenders need to lay out the terms of the financing, including the amount financed and any fees or charges; without such terms there is no enforceable contract. But how lenders disclose these terms so is up to them. This means that small-business credit cost disclosure is haphazard and non-standardized.

For example, TILA requires disclosure of the finance charge, meaning "the dollar amount the credit will cost"[238] which will be an aggregate amount of interest and certain fees and charges. Small-business financiers, however, are not required to disclose the aggregate cost of credit. All the costs of small-business credit must be mentioned somewhere in the lending contract, but they need not be aggregated as they would under TILA.

Likewise, TILA requires an itemization of the amount financed, including the amount disbursed to the consumer.[239] But small-business financiers do not have to disclose the total funds provided net of fees. Instead, they can disclose the gross loan amount,[240] which will make the loan look larger relative to the repayment required.

i. Use of Daily Interest Rates in Lieu of APR

Additionally, in business lending there is generally no standardized credit cost unit disclosure measure, such as the APR. Instead, as discussed in the following sections, small-business lenders often disclose prices in various percentages forms that could readily be confused with an APR by a small-business owner used to seeing APRs in consumer loans.

For example, consider a $400,000 small-business loan made in 2015 by World Business Lenders, LLC, to Homes by DeRamo, Inc., a small,

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237. *See supra* section III.A.
238. 12 C.F.R. § 1026.18(d) (2024).
239. 12 C.F.R. § 1026.18(c)(1) (2024).
240. *See, e.g.*, Knight Capital Funding, Future Receivables Sale Agreement (Aug. 8, 2019), https://www.sec.gov/Archives/edgar/data/1300938/000118518519001167/ex_155737.htm [https://perma.cc/MFG2-LEMQ] (no disclosure of total funds advanced net of fees).

Sarasota, Florida, home construction business owned by the DeRamo family. The loan was personally guaranteed by the DeRamos.[241]

World Business Lenders gave the DeRamos a document entitled "Business Loan Summary," which did not quote an interest rate or an annual percentage rate. Instead, it listed the total interest charge as a dollar amount. The only number given as a percentage in the summary document was the prepayment penalty—15%.[242]

Homes by DeRamo defaulted after seven months and subsequently sued World Business Lenders, alleging that World Business Lenders told them that the interest rate—not the prepayment penalty—was 15%. The actual interest rate was disclosed only in the fine print of the loan agreement and was provided only in the form of a daily interest rate—0.331515959726%.[243] A borrower used to seeing annual rates might reasonably mistake this rate as being a 33.15% annual interest rate. In fact, on an annualized basis, this daily rate translates to over 121%, a shockingly high rate for a loan. The DeRamos' case ultimately settled privately, but it is illustrative of the potential confusion from non-standardized credit cost disclosure.

ii. Use of "Specified Percentage" in Lieu of APR

A particular misleading disclosure arises in the context of MCAs. MCA providers assert that MCAs are not loans but purchases of future receivables, so that credit cost disclosures would not be appropriate.[244] MCAs, however, are widely understood to be an alternative form of financing that can substitute for a loan,[245] however, and the disclosures MCA providers use resemble credit cost disclosures in ways that are misleading.

241. *See* Complaint at ¶¶ 9, 16, DeRamo v. World Bus. Lenders, LLC, No. 8:17-cv-01435 (Fla. Cir. Ct. June 16, 2017) (personal guaranty). For more details, see Transparency in Small-Business Lending, Hearing Before the House Committee on Small Business, 116th Cong. 9-10 (Sept. 9, 2020) (written testimony of Professor Adam J. Levitin).

242. *See* Complaint at ¶ 9, DeRamo v. World Bus. Lenders, LLC, No. 8:17-cv-01435 (Fla. Cir. Ct. June 16, 2017) ("Business Loan Summary) (15% as only number given in percentage terms).

243. *See id.* at 13, ¶ 2 ("Business Promissory Note and Security Agreement" containing a daily interest rate).

244. *See, e.g.*, Complaint at ¶¶ 17-30, Small Bus. Fin. Ass'n v. Hewlett, No. 2:22-cv-08775 (C.D. Cal. Dec. 2, 2022) (objecting to use of credit cost disclosures for sales-based financing).

245. *See, e.g.*, Kassar, *supra* note 108 (discussing MCAs as alternatives to bank loans).

For example, MCA providers will often disclose a "specified percentage,"[246] a "Purchased Percentage,"[247] or a "Monthly Percentage."[248] Whatever the term used, the percentage listed will always be less than 100%.

The "specified percentage" (or similar term) will be the only percentage listed in an MCA's deal documents. It looks like a normal interest rate on a consumer loan, which is exactly what a borrower obtaining financing would expect to see in a deal document, but it is not an interest rate or APR. Instead, it refers to the percentage of receivables that are to be periodically paid over to the MCA provider until the total amount of receivables purchased has been paid in full.

The presence of a single percentage rate that is not the APR on a financing disclosure is inherently confusing because small-business owners—who are consumers first and foremost— are used to seeing the APR as the emphasized percentage rate disclosed in a financing agreement. They would reasonably assume that if a single percentage rate is disclosed that it is the APR, particularly if the percentage is within the range of APRs that they are likely to have seen.

The lack of an APR disclosure for MCAs means that a small business cannot compare the costs of the MCA on an apples-to-apples basis to other MCAs (which might use their own disclosure terminology and layout), much less to non-MCA financing products. The inability of small businesses to engage in effective comparison shopping frustrates price competition and enables MCA providers to charge higher rates than they could in an environment where comparison shopping is easy.

iii. Misleading Use of Tabular Format

The key price terms for offers of consumer credit are typically presented in a tabular format. This is because there is a regulatory safe harbor for TILA compliance for lenders that use the model forms promulgated by the Consumer Financial Protection Bureau ("CFPB").[249] CFPB Model Form H-2 is the model form for closed-end credit. Form H-2 has a four-box tabular structure, with three boxes containing dollar figures and one containing a percentage rate. One of its boxes says "Amount Financed" and another the "Finance Charge". The top of Form H-2 is depicted below in Figure 1.

246. *See, e.g.*, LG Funding LLC, Standard Merchant Cash Advance Agreement (Apr. 12, 2022), https://www.sec.gov/Archives/edgar/data/895665/000149315222010141/ex10-52.htm [https://perma.cc/R7LE-7E9Q] (listing a "specified percentage" of 25%).

247. Knight Capital Funding, Future Receivables Sale Agreement (Aug. 8, 2019), https://www.sec.gov/Archives/edgar/data/1300938/000118518519001167/ex_155737.htm [https://perma.cc/MFG2-LEMQ].

248. Forward Financing MCA, *supra* note 120, at 1018.

249. 15 U.S.C. § 1604(b) (2018).

Figure 1. H-2 Loan Model Form

H-2—Loan Model Form

ANNUAL PERCENTAGE RATE The cost of your credit as a yearly rate.	FINANCE CHARGE The dollar amount the credit will cost you.	Amount Financed The amount of credit provided to you or on your behalf.	Total of Payments The amount you will have paid after you have made all payments as scheduled.
%	$	$	$

Some small business financiers providers use a similar tabular format, but include somewhat different information than in Form H-2. For example, a Future Receivables Sale Agreement (MCA) from Rapid Finance uses a four-box tabular structure.[250] Three of the boxes contain dollar figures, and the fourth a percentage rate. One of the boxes says "Amount Sold" and another the "Discount Charge". The top of the Rapid Finance MCA is depicted below in Figure 2.

Figure 2. Rapid Finance MCA Form

Rapid FINANCE

FUTURE RECEIVABLES SALE AGREEMENT

This **FUTURE RECEIVABLES SALE AGREEMENT** ("Agreement") dated 03/27/2023, is made by and between Small Business Financial Solutions, LLC a Delaware limited liability company ("Purchaser"), and Merchant (as identified below).

Merchant's Legal Name: [redacted] DBA Name: [redacted]

Type of entity (check one): ☐ Corporation ☐ Sole Proprietorship ☐ Limited Liability Company ☒ Other

Purchase Price The dollar amount Purchaser is paying for the Amount Sold.	**Amount Sold** The dollar value of the Future Receivables being sold.	**Discount Charge** The difference between the Purchase Price and the Amount Sold.	**Daily Percentage** The percentage of Future Receivables Merchant agrees to remit to Purchaser each day.
$ 35,000.00	$ 49,350.00	$ 14,350.00	28.00 %

250. Rapid Finance MCA, *supra* note 118, at 996.

Similarly, an MCA agreement from Knight Capital Funding uses a four-box tabular layout, depicted below in Figure 3.[251]

Figure 3. Knight Capital Funding MCA Form

Knight Capital Funding™

FUTURE RECEIVABLES SALE AGREEMENT

This **FUTURE RECEIVABLES SALE AGREEMENT** ("Agreement") dated 08/08/2019 ("Effective Date"), is made by and between the undersigned Knight Capital entity ("Purchaser"), and
ABCO SOLAR, INC. ("Merchant").

Purchase Price:	**Amount Sold:**	**Purchased Percentage:**	**Dollar Amount of Purchased Percentage:**
(The dollar amount Purchaser is paying for the Amount Sold.)	(The amount of Future Receivables being sold by Merchant.)	(The percentage of daily Future Receivables that Merchant agrees to remit to Purchaser.)	(This amount represents the daily dollar amount of the Purchased Percentage based upon the financial information Merchant provided to Purchaser.)
$105,000.00	$144,900.00	12.09%	$823.30

The Rapid Finance and Knight Capital Funding MCAs closely mimic the four-box tabular appearance of Form H-2, but the boxes on the MCAs disclose substantively different information than Form H-2, however. A small-business owner could reasonably—if mistakenly—believe that the MCAs were disclosing the same information as a usual Form H-2 disclosure. In particular, a reasonable small-business owner could reasonably mistake the "Daily Percentage" in the Rapid Finance disclosure or the "Purchased Percentage" in the Knight Capital Funding MCA for the APR because that is the only percentage rate that would be shown in the four-box structure on Form H-2.

The lack of standardization in small-business credit cost disclosure frustrates apples-to-apples price comparisons, which weakens price competition among lenders. Lack of standardization frustrates the informed use of credit and poses a risk of confusion, particularly when the disclosure terminology and layout mimic aspects of consumer credit cost disclosure. The result is to undermine market efficiency and enable supracompetitive pricing, to the detriment of any firm that attempts clear disclosure.

2. Supracompetitive Pricing

The most critical problem in small-business financing is supracompetitive pricing. Inadequate price disclosure contributes to this problem, as businesses may misperceive the cost of financing, but at its core, the supracompetitive pricing problem is a function of lack of competition. Although there are many firms competing to provide small businesses with financing, the informational problems in the small-business

251. Knight Capital Funding, Future Receivables Sale Agreement (Aug. 8, 2019), https://www.sec.gov/Archives/edgar/data/1300938/000118518519001167/ex_155737.htm [https://perma.cc/MFG2-LEMQ].

financing market mean that many small businesses seeking financing, particularly newer, very small, or riskier firms, are unable to get multiple offers on a timely basis. As a result, if they get an offer it is usually a single take-it-or-leave-it, time-limited offer. Thus, even though the small business might have shopped for credit offers with multiple lenders, the small business might only get a single offer to consider, at which point it must make a decision about whether to take the offer without having alternative offers it can consider. The likelihood that a search will be unsuccessful means that the borrower faces high search costs, such that borrowers will not search. Economic theory predicts this will result in every lender acting like a monopolist with supracompetitive pricing.[252]

For consumer credit, usury laws help protect against such supracompetitive pricing by capping the cost of credit. Although usury laws are not expressly keyed to competition issues, they nevertheless restrict pricing when there is situational market power, such as with a consumer with poor credit who is desperate for immediate funding. Such a consumer understands that he is unlikely to get credit offers at all, so when the consumer succeeds in getting an offer, the consumer is unlikely to search for better offers, both because of the likely futility of the search relative to its costs and because of the immediacy of the need for credit. Even if the price of credit is high, the consumer will still take the offer if he is sufficiently desperate and will worry about the consequences at a later time. Usury laws ensure that lenders cannot unduly exploit situational monopoly power in such circumstances.

Usury laws, however, have only limited application to business credit. First, in many states business credit, or at least business credit over a minimal amount, is expressly excluded from the ambit of the usury statute.[253]

Second, business credit agreements will frequently have a choice of law clause that provides that the agreement is governed by the laws of a state, such as Virginia, whose usury laws do not apply to business loans,[254] or Utah, whose usury laws allow all parties to contract for any rate of interest.[255] Whether such choice of law clauses are enforceable varies by state,[256] but when honored, they enable parties to simply contract around

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252. *See supra* text accompanying note 188. This situation holds true even when a platform fintech's insight into a merchant's cashflow addresses the informational problem about the merchant's creditworthiness, as it will be the only party with that insight and ability to overcome the informational problem. *See supra* Part II.C.

253. *See, supra* note 207.

254. VA. CODE § 6.2-317 (2024) (exempting business loans of $5,000 or more from usury laws).

255. UTAH CODE ANN. § 15-1-1 (West 2024).

256. *See* Emmal, *supra* note 211, at 6 (identifying states). Historically, the use of choice-of-law clauses was generally accepted, by courts, *see* Erin Ann O'Hara, *Opting Out of Regulation: A Public Choice Analysis of Contractual Choice of Law*, 53 VAND. L. REV. 1551, 1563-64 (2000),

usury laws. In general, the Restatement (Second) of Conflict of Laws requires there to be a "substantial relationship" to the state whose laws are invoked,[257] but this can often be satisfied by a lender establishing a branch office where payments are to be made, rather than the state being the location of the lender's incorporation or headquarters.

Third, some lenders use "rent-a-bank" arrangements to evade state usury laws. Banks are generally exempt from state usury laws. In a rent-a-bank arrangement, a nonbank piggybacks on the bank's exemption through an arrangement in which the bank makes loans on spec for the nonbank, which then purchases the loans (or a derivative interest in them) from the bank.[258] Rent-a-bank arrangements are susceptible to "true lender" challenges that argue that the bank's involvement is a sham and that the nonbank is the real lender, but the burden of proof in such instances is on the borrower.

Fourth, MCA providers claim that their product is not a loan of money, so therefore it is not subject to state usury laws at all.[259] Again, this characterization can be challenged,[260] but the burden of proof is on the borrower.

The combination of state law exemptions and the use of assorted transactional devices to avoid usury laws means that usury laws fail to protect small businesses against supracompetitive credit pricing. As a result small businesses can find themselves paying costs that are equivalent to annual interest rates approaching 4,000%.[261]

but more recently some courts have declined to enforce such provisions. *See, e.g.*, Fleetwood Servs., LLC v. Complete Bus. Sols. Grp., 374 F. Supp. 3d 361, 372 (E.D. Pa. 2019) (declining to enforce choice of law provision because it would "violate a fundamental public policy of Texas, namely its antipathy to high interest rates"); Am. Equities Grp. v. Ahava Dairy Prods. Corp., 2004 WL 870260, at *7–9 (S.D.N.Y. Apr. 23, 2004) (declining to enforce a choice law provision in case involving usury defense); Am. Express Travel Related Servs. Co. v. Assih, 893 N.Y.S.2d 438, 445-46 (N.Y. Civ. Ct. 2009) (declining to enforce a choice of law provision based on the "strong public policy against interest rates which are excessive").

257. Restatement (Second) Conflict of Laws §§ 187, 203.

258. *See generally* Levitin, *Rent-a-Bank*, *supra* note 72 (discussing rent-a-bank arrangements).

259. *See* Stevens, *supra* note 36, at 517.

260. *See supra* note 148 (listing cases with successful challenges to characterization of MCAs as true sales).

261. Complaint at ¶ 67, New York v. Richmond Capital Group LLC, No. 451368/2020 (N.Y. Sup. Ct., June 10, 2020) ("The merchant's annual interest rate, including interest that was purportedly "fees," was 3,910 percent."); *see also* Memorandum of Law in Support of Motion for Summary Judgment in Lieu of Complaint, Novac Equities, LLC v. Randazzos Clam Bar of N.Y., No. 65774/2022 (N.Y. Sup. Ct. Sept. 28, 2022) at 2-3 (effective APR of 2,275% based on dividing the difference between the amount of future receipts purchase ($127,920) and the advance ($72,000) by the amount of the advance and then annualizing based on the 20-day repayment period).

3. Abusive Collection Practices

Supracompetitive pricing in small-business lending is compounded by abusive collection practices that make it difficult for small businesses to defend against illegal actions by lenders. Three legal practices contribute to this situation.[262]

a. Mandatory Electronic Payment

First, small-business lenders frequently tie the extension of credit to the requirement of preauthorizing electronic debits of an account by the lender. Such an arrangement is particularly common for MCAs, where the MCA provider will often have a right to debit the small business's account at its payment processor.[263] Platform fintechs (or those that partner with platforms like Amazon) have a similar arrangement, as they can simply offset whatever funds they owe the merchant on sales.[264]

The lender's ability to unilaterally debit the business's funds means that the lender can decide whether, when, and how much to debit. The lender, not the borrower, decides when it gets repaid, and the lender can even illegally debit the business's account for funds to which it is not entitled, including after loans have been repaid in full.[265]

Critically, this means that if there is a dispute, the borrower cannot withhold funds other than by closing out the account—which would not only be disruptive to the borrower's business, but would likely constitute an event of default on the loan, enabling the lender to pursue other remedies, including pursuing the small business's owner on a personal guaranty.

262. Illegal loan shark style collection tactics, such as outright threats of violence against borrowers, or as well as falsely declaring defaults, are also a concern in the small-business lending space. *See, e.g.*, Petition, New York v. Yellowstone Capital LLC, No. 450750/2024 (Mar. 5, 2024, N.Y. Sup. Ct.), at ¶¶ 502-09 (descriving false declarations of default); Michael S. Schmidt, Maggie Haberman, Jonathan Swan & Alan Feuer, *A Troubling Trump Pardon and a Link to the Kushners*, N.Y. TIMES (Nov. 26, 2023), https://www.nytimes.com/2023/11/26/us/politics/trump-pardon-braun.html [https://perma.cc/VE5X-ZB7H] (describing loan shark threats of violence).

263. *See, e.g.*, Rapid Finance MCA, *supra* note 118, at 998 ("Purchaser agrees to accept the remittance of the Daily Percentage in one of the following ways: (i) directly from the Merchant's card processor; (ii) by debiting the Merchant's bank account; or (iii) by debiting a deposit account established by Merchant that is approved by Purchaser.").

264. *See, e.g.*, *Parafin Flex Loan Program*, PARAFIN 5-6, https://parafin-assets.s3.amazonaws.com/legal/parafin_flex_loan_agreement.pdf [https://perma.cc/38UW-YSTE] ("Beginning on the Repayment Start Date, you authorize us to withhold funds each repayment period in the amount of the Repayment Rate from your Merchant Receivables for purposes of repaying your Loan."); PARAFIN 3 (Feb. 28, 2022), https://assets.parafin.com/legal/MerchantTermsOfService_20220228.pdf [https://perma.cc/4FF6-3K5E] ("To use the Advance Service in conjunction with a Marketplace where Parafin is directly integrated with the Marketplace's payment processor, Provider hereby authorizes Parafin to deduct the Percentage of Daily Sales directly from the payment processor prior to such payment processor's payment to Provider.").

265. *See, e.g.*, Complaint at ¶¶ 69-78, New York v. Richmond Capital Group LLC, No. 451368/2020 (June 10, 2020, N.Y. Sup. Ct.).

Instead, if there is a dispute, the borrower must instead attempt to claw back the funds from the lender. Because of the debit, however, the borrower lacks the funds to pay for litigation, and if the amount at stake is too small, a contingency-fee arrangement will not be practical. The ability to unilaterally debit or offset funds gives the lender substantial leverage in the relationship and enables lenders to overreach and improperly debit funds to which they are not in fact entitled. In the consumer context, such mandatory use of electronic payment as a condition of credit is prohibited.[266]

b. Ex Parte Pre-Judgment Attachment

Second, some small-business lenders use a feature allowed by some state laws for ex parte pre-judgment attachment. Pre-judgment attachment allows a lender to seek a court order for an asset freeze on the borrower's assets prior to a decision on the merits as to whether funds are in fact owed by the borrower. Some states permit ex parte pre-judgment attachment, which means that the borrower does not even have an opportunity to object and be heard about the issue of attachment before the asset freeze order is issued. In particular, in Connecticut an ex parte pre-judgment attachment is allowed in commercial loans from before July 1, 2024 if the borrower has waived the right to a hearing in the loan documents.[267]

Lenders can use choice of law clauses to opt into state legal regimes that permit ex parte pre-judgement attachment and then export the attachment orders to financial institutions in other states.[268] With their funds frozen, borrowers have little ability to fight the attachment or an ultimate judgment.

266. 15 U.S.C. § 1693k(1) (2018). Consumers are always free to opt-in to such an arrangement.

267. *See, e.g.*, CT. GEN. L. § 52-278f (2024). *See also Ex Parte Prejudgment Attachment: Connecticut's Secret Sauce*, BARCLAY DAMON LLP (Oct. 19, 2023), https://www.barclaydamon.com/alerts/ex-parte-prejudgment-attachment-connecticuts-secret-sauce [https://perma.cc/L3ZX-SZ76] (discussing operation of Connecticut ex parte pre-judgment attachment). The constitutionality of such a remedy is questionable. The Supreme Court struck down Connecticut's pre-judgment attachment statute for real estate. Connecticut v. Doehr, 501 U.S. 1 (1991), and it has also previously struck down other pre-judgment remedies. *See* Snaidich v. Family Finance Corp., 395 U.S. 337 (1969) (striking down pre-judgment wage garnishment statute); Fuentes v. Shevin, 407 U.S. 67 (1972) (striking down pre-judgment replevin statute). Connecticut has subsequently amended its commercial financing law to prohibit the enforceability of waivers of notice before prejudgment attachment. CONN. GEN. STAT. § 36a-868 (2024).

268. *See* Zachary Mider & Zeke Faux, *Sign This Agreement and Your Bank Account Might Be Frozen*, BLOOMBERG (Feb. 10, 2022), https://www.bloomberg.com/news/features/2022-02-10/predatory-lenders-are-using-legal-tricks-to-freeze-borrowers-bank-accounts [https://perma.cc/3L4L-R8DY].

c. Confessions of Judgment

Third, a number of states permit accelerated collection activity through "confessions of judgment" that allow a lender to obtain a default judgment administratively from the clerk of the court without notice or a hearing.[269] The lender can then take the default judgment to a sheriff or marshal to enforce, such as through a garnishment order against a bank. The result is that the borrower may lose its funds based on a claimed default without ever having a chance to contest the default. At that point, the borrower has little ability to litigate the alleged default because it lacks the funds to do so.

The use of confessions of judgment for consumer debtors is prohibited by the FTC's Credit Practices Rule,[270] but the rule does not protect consumer guarantors of business obligations. Many small-business lenders, particularly MCA providers, include a confession of judgment in their lending agreements.[271] Although not all states permit confessions of judgment,[272] contractual choice of law clauses again provide the simple workaround.

What we see, then is that small-business lending has neither the protection of competition nor the protection of regulation, such that problems exist in terms of credit cost disclosure, supracompetitive pricing, and abusive collection practices.

C. Impact of Lack of Regulation: 2,275% APR Financing

Many of the problems in small-business financing can be seen in the saga of Randazzo's Clam Bar, an iconic New York restaurant, "the pride of Sheepshead Bay," "serving Brooklyn since 1932."[273] As Randazzo's faced financial difficulty, it found itself borrowing repeatedly from nonbank lenders, first with a loan and then with MCAs of higher and higher cost. Most of Randazzo's borrowings ever clearly disclosed the cost of the credit because they were not formally structured as loans. All the

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269. *See, e.g.*, VA. CODE § 8.01-431 (2024). In response to concern about the use of confession of judgments in small-business lending, some states have recently curtailed their use. *See, e.g.*, N.J. STAT. ANN. § 2A:16-9.1(a)(1) (2020) (prohibiting use of confession of judgments against New Jersey businesses); N.Y. C.P.L.R. § 3218 (Consol. 2019) (as amended by S.B. 6395, 2019 Leg. (N.Y. 2019)) (limiting use of confession of judgments to in-state debtors).

270. 16 C.F.R. § 444.2(a)(1) (2024).

271. *See* Zachary R. Mider & Zeke Faux, *"I Hereby Confess Judgment*,*"* BLOOMBERG (Nov. 18, 2018) https://www.bloomberg.com/graphics/2018-confessions-of-judgment [https://perma.cc/M4FH-QA4E]. Zachary R. Mider & Zeke Faux, *Rubber-Stamp Justice*, BLOOMBERG (Nov. 29, 2018), https://www.bloomberg.com/graphics/2018-confessions-of-judgment-new-york-court-clerks [https://perma.cc/53NX-FE3X].

272. In 2019, New York banned the use of confessions of judgment in New York courts for out-of-state businesses, but they are still permitted for New York borrowers. N.Y. C.P.L.R. 3218 (Consol. 2019) (as amended by S.B. 6395, 2019 Leg. (N.Y. 2019)).

273. *Serving Brooklyn Since 1932*, RANDAZZO'S CLAM BAR, https://www.randazzosclambarnyc.com/history [https://perma.cc/62QU-SJJY].

borrowings were personally guaranteed.[274] Some purported to be governed by out-of-state law.[275] And all either had confessions of judgment or electronic debit rights.[276]

In the summer of 2022, Randazzo's was in serious financial trouble. The COVID-19 pandemic had depressed business for the previous two years at Randazzo's, like many other restaurants.[277] Desperate for the cash to stay afloat, Randazzo's turned to a series of extraordinarily high-cost financing transactions that all but guaranteed its failure.[278]

First, in December 2021, Randazzo's obtained a 15-month $117,000 installment loan from an on-line lender called ODK Capital, LLC, doing business as "OnDeck Capital."[279] The loan was personally guaranteed by Paul Randazzo, the restaurant's owner,[280] and secured by virtually all of Randazzo's property, including rights to future credit and debit card payments.[281] The loan also permitted OnDeck Capital to automatically debit Randazzo's bank account.[282] The loan, which was governed by Virginia law,[283] had an annual percentage rate (APR) of 68.84%, a rate that is unusually high for consumer or business loans.[284]

The OnDeckCapital loan, however, did not provide enough financing for Randazzo's. A month later, in January 2022, Randazzo's obtained more financing via an MCA from a firm called Funding Metrics, LLC, doing business as "Lendini."[285] Lendini provided Randazzo's with an immediate

274 Proof of Claim, Claim 12, Attachment 1, at 15, In re Randazzo's Clam Bar of NY Inc, No. 23-41151 (Bankr. E.D.N.Y. Apr. 3, 2023); Proof of Claim, Claim 8 at 20, *In re Randazzo's Clam Bar of NY Inc*, No. 23-41151 (Bankr. E.D.N.Y. Apr. 3, 2023); Affidavit in Support of Motion for Summary Judgment in Lieu of Complaint, *Novac Equities, LLC v. Randazzos Clam Bar of N.Y.*, No. 65774/2022, at 2-3 (N.Y. Sup. Ct. Sept. 28, 2022) at Exhibit A, at 15; Decision and Order on Motion, *Forever Funding LLC v. Randazzos Clam Bar of N.Y.*, No. 65773/2022, at 2-3, 26 (N.Y. Sup. Ct. Oct. 27, 2022) (noting personal guaranty).

275 Proof of Claim, Claim 12, Attachment 1, at 14, *In re Randazzo's Clam Bar of NY Inc*, No. 23-41151 (Bankr. E.D.N.Y. Apr. 3, 2023).

276 Proof of Claim, Claim 12, Attachment 1, at 16, *In re Randazzo's Clam Bar of NY Inc*, No. 23-41151 (Bankr. E.D.N.Y. Apr. 3, 2023); Proof of Claim, Claim 8 at 9, *In re Randazzo's Clam Bar of NY Inc*, No. 23-41151 (Bankr. E.D.N.Y. Apr. 3, 2023); Judgment by Confession, *DMKA LLC v Randazzo's Clam Bar of NY Inc*, No. 22-523085 (Ny. Sup. Ct. Aug. 11, 2022); Affidavit in Support of Motion for Summary Judgment in Lieu of Complaint, *Novac Equities, LLC v. Randazzos Clam Bar of N.Y.*, No. 65774/2022, at 2-3 (N.Y. Sup. Ct. Sept. 28, 2022) at Exhibit A, at 4.

277. Local Rule 1007-Affidavit at 1, *In re Randazzo's Clam Bar of NY Inc.*, No. 23-41151 (Bankr. E.D.N.Y. Apr. 3, 2023).

278. *Id.* ("In order to survive, we were forced to take high interest rate merchant cash advance loans[,] which has crippled our cash flow.").

279. Proof of Claim, Claim 12, Attachment 1, at 1-2, In re Randazzo's Clam Bar of NY Inc, No. 23-41151 (Bankr. E.D.N.Y. Apr. 3, 2023).

280. *Id*. at 15.

281. *Id.* at 5, 22.

282. *Id.* at 16.

283. *Id.* at 14.

284. *Id.* at 2.

285. Funding Metrics, LLC, Form UCC1, No. 202202085225489 (Feb. 8, 2022) (noting purchase of future receivables on or about January 5, 2022). It is unclear if the name "Lendini" is supposed to evoke the great escape artist Harry Houdini, who could get out of any bind.

payment of $73,500 in exchange for $108,750 to be paid from Randazzo's *future* receipts.[286] The Lendini MCA is insistent that it is a sale of future receivables, not a loan: the first page of the agreement begins with "THIS IS NOT A LOAN" in all caps in a font that is easily double the size of any other text in the agreement.[287]

The future revenue was to be delivered on a daily basis to Lendini based on a specified percentage (9.97%) of the Randazzo's projected sales until Randazzo's had paid the total amount of future receipts.[288] Although the specified percentage indicated an anticipated repayment over 180 days,[289] the MCA did not have a due date, as payments would be smaller if Randazzo's revenues were less than anticipated. The MCA, which was personally guaranteed by Paul Randazzo,[290] permitted Lendini to automatically debit Randazzo's bank account.[291] The effective APR for the transaction—which was never disclosed—was approximately 170%, more than double that of the already expensive OnDeck loan.[292]

By March 2022, Randazzo's was clearly struggling, paying late on its OnDeck Capital loan.[293] Then over the spring and summer of 2022, Randazzo's entered into four additional MCA transactions within the space of three months. On May 5, 2022, Randazzo's obtained a merchant cash advance of approximately $90,000 from a company called DMKA LLC (doing business as "The Smarter Merchant") in exchange for $140,400 future receipts.[294] The specified repayment percentage or periodic repayment amount for this transaction is not public, so an APR cannot be calculated.

286. Proof of Claim, Claim 8 at 5, In re Randazzo's Clam Bar of NY Inc, No. 23-41151 (Bankr. E.D.N.Y. Apr. 3, 2023).

287. *Id.* at 5.

288. *Id.*

289. The anticipated repayment period is not statedbut can be calculated by dividing the amount purchased by the daily estimated payment.

290. Proof of Claim, Claim 8, at 20-21, In re Randazzo's Clam Bar of NY Inc, No. 23-41151 (Bankr. E.D.N.Y. Apr. 3, 2023).

291. *Id.* at 9.

292. It is possible to calculate an implicit APR for an MCA based on the stated percentage, the amount of future receivables sold, and the anticipated repayment period. For APR calculations, I used the Federal Financial Institutions Examinations Council's APR Tool. *See* https://www.ffiec.gov/examtools/FFIEC-Calculators/APR/#/accountdata. When using the APR Tool, I used the amount of the advance for the "Amount Financed" and the amount of the future receipts for "Disclosed Total of Payments." Good faith use of the tool entitles a creditor to a regulatory safe harbor. 12 C.F.R. § 1026.22(a) (2024). The use of APR for MCAs is a controversial issue, addressed *infra,* Part III.B.1.ii.

293. Proof of Claim, Claim 12, Attachment 1 at 19, In re Randazzo's Clam Bar of NY Inc, No. 23-41151 (Bankr. E.D.N.Y. Apr. 3, 2023), (logging payment history).

294. Judgment by Confession, DMKA LLC v. Randazzo's Clam Bar of NY, Inc. No. 523085/2022 (N.Y. Sup. Ct. Aug. 11, 2022) (NYSCEF Doc. 1 at 1). The docket in the case does not reveal the amount paid by DMKA for the future receivables; but based on the terms of the subsequent MCAs entered into by Randazzo's, the amount of the advance would have been approximately $90,000 or roughly 60% of the future receipts purchased

Two months later, on July 7, 2022, Randazzo's obtained a $58,500 merchant cash advance from Forever Funding, LLC, in exchange for $97,500 of future receipts, which were expected to be repaid from 18% of its future receipts over 50 days.[295] The effective annual percentage rate (APR) for the transaction—which was never disclosed—was approximately 811%, a level virtually unseen in *any* financial transactions.[296]

Two weeks after that, Randazzo's obtained yet another merchant cash advance of $50,000), this time from Seamless Capital Group, LLC, in exchange for $78,950 in future receipts.[297] Randazzo's promised to pay 49% of its daily receipts with payments estimated at $1,799 per day, thus implying a 44 day term.[298] The APR for the transaction—which was never disclosed—was approximately 850%, an even more astonishingly high cost.[299]

Then, two days later, Randazzo's obtained yet another merchant cash advance of $72,000, this time from Novac Equities, LLC, in exchange for $127,920 in future receipts.[300] This advance was to be repaid from 18% of its future receipts over 20 days.[301] The effective APR for the transaction—which was never disclosed—was approximately a jaw-dropping 2,275%![302]

295. Affidavit in Support of Motion for Summary Judgment at 2, 26, Forever Funding LLC v. Randazzos Clam Bar of N.Y., No. 65773/2022, at 2-3, 26 (N.Y. Sup. Ct. Sept. 28, 2022) (displaying Randazzo's ledger with Forever Funding). The anticipated repayment period is not stated but can be calculated by dividing the amount purchased ($97,500) by the daily estimated payment ($1,950). Future Receivables Sale and Purchase Agreement, Forever Funding LLC v. Randazzos Clam Bar of N.Y., No. 65773/2022 (N.Y. Sup. Ct. Sept. 28, 2022) (Dkt. No. 5).

296. The APR was calculated using the Federal Financial Institutions Examination Council's on-line APR tool, https://www.ffiec.gov/resources/computational-tools/apr. The amount financed was listed as $58,500, the finance charge as $39,000 (that is the difference between $97,500 and $58,500), and an installment loan structure with payment frequency in actual days and 1 day per unit period was specified, as were payments of $1,950 over 50 days at 1 unit period. The resulting APR is 811.4067%.

297. Verified Complaint at 2-3, Seamless Capital Group LLC v. Randazzo Clam Bar of NY, Inc., No. 526529/2022 (N.Y. Sup. Ct. Sept. 12, 2022).

298. Seamless Capital Group LLC v. Randazzo Clam Bar of NY, Inc., No. 526529/2022, (N.Y. Sup. Ct. Sept. 12, 2022), docket number 5 ("Future Receivables Sale and Purchase Agreement).

299. The APR was calculated using the Federal Financial Institutions Examination Council's on-line APR tool, https://www.ffiec.gov/resources/computational-tools/apr. The amount financed was listed as $50,000, the finance charge as $28,950 (that is the difference between $78,950 and $50,000), and an installment loan structure with payment frequency in actual days and 1 day per unit period was specified, as were payments of $1,799 over 43 days plus 1 day at $1593, each for 1 unit period. The resulting APR is 854.1544%.

300. Memorandum of Law in Support of Motion for Summary Judgment in Lieu of Complaint, Novac Equities, LLC v. Randazzos Clam Bar of N.Y., No. 65774/2022, at 2-3 (N.Y. Sup. Ct. Sept. 28, 2022).

301. The anticipated repayment period is not stated but can be calculated by dividing the amount purchased by the daily estimated payment.

302. The APR was calculated using the Federal Financial Institutions Examination Council's on-line APR tool, https://www.ffiec.gov/resources/computational-tools/apr. The amount financed was listed as $72,000, the finance charge as $55,920 (that is the difference between $127,920 and $72,000), and an installment loan structure with payment frequency in actual days

In total, Randazzo's Clam Bar sold off at least 95%, and likely over 100%, of its future receipts for several weeks at around a 33% average discount, having already pledged these receipts as collateral to OnDeck Capital.[303] In other words, in exchange for $285,000 up front, Randazzo's promised to pay the MCA providers $444,700 within a few weeks.[304] Although the MCA transactions put immediate cash in Randazzo's coffers, they also meant that Randazzo's, which was already struggling, would find it even harder to remain solvent because it would not be able to use most of its future revenue, even for regular operating expenses, like paying employees and utilities, purchasing raw ingredients, and maintaining insurance.

Not surprisingly, the repayment burden from the MCAs proved too much for Randazzo's. By August 2022, Randazzo's was already in default on all of the MCAs.[305] Faced with close to $400,000 in liability on the MCAs,[306] Randazzo's filed for bankruptcy several months later.[307] At the time of the bankruptcy, Randazzo's had 11 employees.[308]

Randazzo's bankruptcy petition and the claims register for its bankruptcy case reveal no bank creditors. Instead, its only financial creditors were OnDeck Capital and the various MCA providers.

The situation faced by Randazzo's is a common one for financially fragile small businesses, which find themselves borrowing at shockingly high rates from MCA providers and other on-line "fintech" lenders rather than banks. The resort to high-cost lending is a function of both the peculiar informational challenges of small-business financing and the near complete lack of regulatory protections for small-business borrowers.

Randazzo's story illustrates several features of the small-business lending landscape. First, the financings all required a personal guaranty.[309]

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and 1 day per unit period was specified, as were payments of $6,396 over 20 days at 1 unit period. The resulting APR is 2,274.6601%.

303. *See supra* note 282.

304. *See supra* notes 282-301 and accompanying text.

305. Order to Show Cause, DMKA LLC v. Randazzo's Clam Bar of NY, Inc. No. 523085/2022, at 2 (N.Y. Sup. Ct. Sept. 15, 2022); Memorandum of Law in Support of Motion for Summary Judgment in Lieu of Complaint, Forever Funding LLC v. Randazzos Clam Bar of N.Y., No. 65773/2022, at 2 (N.Y. Sup. Ct. Sept. 28, 2022); Memorandum of Law in Support of Motion for Summary Judgment in Lieu of Complaint, Novac Equities, LLC v. Randazzos Clam Bar of N.Y., No. 65774/2022, at 2 (N.Y. Sup. Ct. Sept. 28, 2022); Verified Complaint at 3, Seamless Capital Group LLC v. Randazzo Clam Bar of NY, Inc., No. 526529/2022 (N.Y. Sup. Ct. Sept. 12, 2022). The DMKA MCA default resulted in a levy on Randazzo's payments processor by the New York City Marshal, following which the parties ultimately settled for $40,000 to be paid out from funds held by the payment processor. Order to Show Cause, DMKA, LLC vs. Randazzo's Clam Bar of NY, Inc., No. 523085/2022, at 3 (N.Y. Sup. Ct. Sept. 15, 2022).

306. The total liability accounts for repayments made and attorneys' fees and interest and other fees claimed by the MCA providers.

307. Voluntary Petition for Non-Individuals Filing for Bankruptcy, In re Randazzo's Clam Bar of NY Inc, No. 23-41151, at 1-6 (Bankr. E.D.N.Y. Apr. 3, 2023).

308. Disclosure Statement, In re Randazzo's Clam Bar of NY Inc, No. 23-41151, at 2 (Bankr. E.D.N.Y. Apr. 3, 2023).

309. *See supra* note 274.

Second, the financings all required the lender to have electronic bank account withdrawal rights, so no judicial order was needed for collection.[310] Third, the financings lacked standardized credit cost disclosures. Fourth, the costs of the financings ranged from pricey to exorbitant, but the financings were all structured so as to avoid the application of New York's usury law. For example, Randazzo's 68.84% APR loan from On Deck Capital would have violated New York's criminal usury statute, which applies to loans with annual interest rates of 25% or higher,[311] but the loan purported to be governed by Virginia law.[312] Likewise, the MCAs would have all violated New York's criminal usury statute—but the statute only applies to loans of money, not the sales of future receivables, as the MCAs purport to be.[313]

IV. Explaining the Difference in Regulatory Regimes

The difference between heavily regulated consumer lending and scantily regulated business lending begs the question of why consumers receive greater regulatory protection than businesses. It is hard to prove a story about the reasons for lack of regulation, but a common explanation is that business lending is not regulated because business borrowers have the financial sophistication to look out for their own interests. This Article rejects this explanation and posits an institutional explanation: business lending was historically regulated or restrained through various channels, but changes in the market have undermined those restraints.

A. Differences in Financial Sophistication

A common explanation for the difference in consumer and small-business lending regulatory regimes is based on a supposed difference in financial acumen between consumers and businesses: businesses, unlike consumers, are supposed to be sophisticated entities that can look out for their own interests and therefore do not need market-distorting regulatory interventions.[314]

This argument resonates when applied to large business interests that employ specialized financial officers, but such firms are by far the exception among American businesses. The supposed difference in sophistication does not hold up under closer inspection for small

310. *See supra* note 276.

311. N.Y. PENAL L. § 190.40 (Consol. 2024). New York's civil usury law, N.Y. BANKING L. § 14-A (1) (Consol. 2024), which imposes a 16% annual interest rate cap, does not apply to corporate borrowers. N.Y. GEN. OBLIG. L. § 5-521(1) (Consol. 2024).

312. *See supra* note 283.

313. N.Y. PENAL L. § 190.40 (Consol. 2024).

314. *See, e.g.*, Cline, *supra* note 40, at 221 (arguing that the benefit of mandatory commercial credit cost disclosures are negligible given "the sophistication and financial acumen of the persons" they seek to protect).

businesses, the vast majority of which are owner-operated affairs without any other employees.[315] In such a situation, the sophistication of the business is merely that of the owner-operator, who is just a consumer and is unlikely to have any specialized financial knowledge or sophistication.

Consider, for example, a sole proprietorship where the decision-maker is the consumer-proprietor. If the sole proprietor lacks such sophistication about finances that she merits the intervention of a federal regulatory regime in her personal finances, why would she not need the same regime in her business dealings? The sole proprietor may well have expertise and sophistication in the subject of her business, say landscape architecture or dry cleaning or cosmetic surgery or fashion retailing. But it hardly follows that engaging in business imparts her with any particular financial sophistication. The same holds true for incorporated small businesses without employees. Indeed, one survey found that 40% of small-business owners consider themselves to be financially illiterate.[316] Nevertheless, federal regulation of business lending extends only to anti-discrimination; it does not regulate credit term disclosure or the substantive terms of credit, including cost.

Most small businesses are merely incorporated versions of their owner-operator. This means that there is no principled reason for excluding businesses, or at least small ones, from consumer credit regulation, particularly given that most small-business credit is underwritten based in part or in whole on the owner-operator's personal credit.

B. Existence of Alternative Borrower Protections

If the sophistication story does not ring true, what, then explains the difference in regulatory treatment? The answer may lie in historical institutional differences. Unlike consumer lending, small-business lending has, historically, had institutional features that kept a check on overreaching or abusive lending practices. The presence of these institutional features negated the need for regulation of small-business lending.

Historically, small-business lending was dominated by community banks, which made their loans with SBA guarantees.[317] SBA interest rate caps constrained banks from making excessively risky loans to small

315. *See supra* note 53.

316. *QuickBooks Survey: More Than 40 Percent of Small-business owners Identify as Financially Illiterate*, INTUIT (Nov. 13, 2014), https://investors.intuit.com/news-events/press-releases/detail/578/quickbooks-survey-more-than-40-percent-of-small-business-owners-identify-as-financially-illiterate [https://perma.cc/N4HG-K67Z].

317. *See* Julapa Jagtiani & Raman Quinn Maingi, *How Important Are Local Community Banks to Small Business Lending? Evidence from Mergers and Acquisitions* 2, Fed. Reserve Bank of Phila. Working Paper 18-18, (Aug. 2019), https://www.philadelphiafed.org/-/media/frbp/assets/working-papers/2018/wp18-18.pdf [https://perma.cc/98GA-GV55].

businesses. SBA regulation historically covered a large part of the small-business lending market, such that there was scant need for general federal or state regulation of small-business lending.

Additionally, community banks were (and are) subject to reputational constraints based on their physical location in their communities and their desire to cultivate long-term, multi-product relationships with not just small businesses' borrowers, but also with the businesses' owners.[318] For community banks, future business development requires maintaining a positive reputation. This repeat player dynamic incentivizes community banks to deal with their local customers on fair terms. As a result, predatory small-business lending by banks simply was not a major issue historically.

In consumer lending, many of these constraints do not exist or are looser, so regulation compensates. In consumer lending, banks are not generally subject to interest rate caps,[319] and reputational constraints are weaker in part because megabanks that operate nationally play a much greater role in consumer lending markets and are not as likely to be concerned about local reputation.[320]

Small-business lending has charged institutionally in the past two decades. In particular, the emergence of fintech small-business lenders poses a challenge to the assumption that the small-business lending market's institutional features negate the need for regulation. Fintech small-business lenders that operate outside of SBA guaranty programs are not subject to any of the SBA's constraints on loan terms. Likewise, fintech lenders do not have the reputational constraints as community banks because they are not community-based nor do they seek to develop broad, multi-product cross-selling relationships with customers that require a positive reputation. Not surprisingly, the concerns about abusive small-business lending practices are concentrated on fintech lenders.

V. Reforming Small-Business Finance Regulation

As we have seen, informational problems make it difficult for new, very small, or riskier small businesses to get competing credit offers. The lack of competition, coupled with the lack of regulation of non-SBA-guaranteed small-business lending has left these small-business borrowers vulnerable to abusive lending practices, particularly supracompetitive pricing and aggressive collection procedures.

The information problems in small-business lending stand as an obstacle to improving competition and are not easily remedied. The

318. *See supra* Part I.B.3.

319. Levitin, *Rent-a-Bank*, *supra* note 72, at 332.

320. In credit cards, for example, the top ten issuers had 83% of total US purchase volume in 2023. *Nilson Report, Issue 1258*, NILSON REPORT 4 (Feb. 2024), https://nilsonreport.com/newsletters/1258 [https://perma.cc/Y42D-BNVW].

consumer credit reporting system does not readily translate to business credit. Unlike consumers, businesses can be created and dissolved at will. Whereas negative credit reporting data can stay on a consumer's file for up to a decade,[321] a small business can simply close shop and restart under a different name with a fresh credit file. Additionally, new businesses or businesses that have not previously had credit are like "thin file" or "credit invisible" consumers, but business borrowers lack standard consumer credit history on-ramps: parent co-signors, student loans, and secure credit cards. At best, a small business can get credit based on a personal guaranty by an owner.

Given that the market failure from informational problems is unlikely to be solved any time soon, it is to regulation that we must turn to address the abuses in small-business lending. In response to the market failure caused by asymmetrical information between small businesses and would-be lenders, this Article proposes a comprehensive federal small-business financing regulatory regime. This regime, which would require a combination of federal legislation and implementing rulemaking, would apply to all business financings of less than a specified amount, say $1 million, that are personally guaranteed by an individual ("covered small-business financings").

A figure of $1 million should be large enough to cover almost all lending to microenterprises while ensuring the regime would not apply to larger small-business financings in the middle market, where borrowers are presumably more financially savvy, as they are not simply incorporated versions of ma-and-pa. Having a personal guaranty as an additional required trigger would also underscore that these small-business loans are in part, if not primarily, underwritten based on *consumer* credit, so consumer credit-type disclosures should apply. At the same time, the regime would not apply to financings that are not personally guaranteed, as in these situations, the lender is taking a risk on a corporate entity alone, so the harms from supracompetitive pricing are not affecting individuals.[322]

Critically, the regime would apply to all covered small-business financings, regardless of form. To this end it would define "credit" to include not just the right to defer payment of a debt, but also all asset sales of less than $1 million that are personally guaranteed. This would sweep in MCAs that are personally guaranteed, thereby ending the regulatory arbitrage based on the fiction that MCAs are actually asset purchases, rather than intended as security.

The proposed regulatory regime would have seven elements. First, it would impose a disclosure regime based on the Truth in Lending Act. Adapting such a disclosure regime to sales-based financings, which do not have a

321. 15 U.S.C. § 1681c (2018).

322. If a platform would tie eligibility for a business to an owner's previous businesses being in good standing, that should be treated as an implicit guaranty requirement.

specified due date, would present some challenges, but state-level disclosure regimes have managed to do this with the use of assumptions about payback periods.[323] While one might reasonably question the value of credit cost disclosure in general,[324] what is sauce for the consumer goose should also be good for the small-business gander. As long as disclosure remains the cornerstone of consumer credit regulation, it should also apply to small-business credit that is based on the credit characteristics of the small-business owner.

Second, the proposed regulatory regime would require covered small-business financings be treated as consumer credit for purposes of state usury laws, thereby preempting state exclusions of business credit. In this regard, the federal regime would maintain the long-standing system of generally deferring to the states in setting usury rates,[325] but it would override state laws that exempt business loans from state usury laws, at least to the extent that the loans are covered small-business financings (that is, under the specified dollar threshold and personally guaranteed). For states that do not specify a usury rate, but instead defer to the contractual rate, a federal usury ceiling could be specified.[326] Application of state usury laws with a federal backstop would help address supracompetitive pricing.

Third, the proposed regulatory regime would apply the anti-tying provision of the Electronic Fund Transfer Act[327] to covered small-business loans, so that covered small businesses would not be forced into electronic payment arrangements, but would instead be able to bargain for them.

Fourth, the proposed regulatory regime would extend the FTC's Credit Practices Rule[328] to covered small-business financings. This would bar confessions of judgment for covered small-business financings.

Fifth, the proposed regulatory regime would provide that it is an unfair practice within the meaning of the FTC Act[329] for a covered small-business loan to have a choice of law provision that selects the law of a

323. *See, e.g.*, CAL. CODE REGS. tit. 10, § 914 (2024) (special disclosures for sales-based financing).

324. *See generally* OMRI BEN-SHAHR & CARL SCHNEIDER, MORE THAN YOU WANTED TO KNOW: THE FAILURE OF MANDATED DISCLOSURE (2014) (critiquing disclosure regulation).

325. The CFPB is prohibited from promulgating a regulatory usury limit. 12 U.S.C. § 5517(o) (2018). There is a federal usury limit, however, for certain loans made to active-duty military members and their dependents, 10 U.S.C. § 987 (2018), and federal law places limits on the maximum interest rate certain financial institutions can charge. 12 U.S.C. §§ 85 (2018) (national banks), 1757(5)(A)(6) (2018) (federal credit unions), 1831(d) (2018) (state-chartered insured banks). Federal law also limits the pricing of limits the pricing of certain federally guaranteed products. *See* 13 C.F.R. § 120.214 (2024) (codifying the SBA Section 7(a) loan guaranty rate cap).

326. This Article side-steps the tricky question of what such a level should be but notes that an alternative federally set rate has long existed for national banks. *See* 12 U.S.C. § 85 (2018).

327. 15 U.S.C. § 1693k(1) (2018).

328. 16 C.F.R. pt. 444 (2024).

329. 15 U.S.C. § 45(a) (2018).

jurisdiction other than that of the primary location of the small business or its state of incorporation. Choice of law provisions have become weaponized to enable regulatory arbitrage for usury and collection tactics. Small-business borrowers are unlikely to understand the importance of the choice of law, just as consumers are unlikely to understand the significance of binding mandatory arbitration or class action waivers or choice of law clauses,[330] so they are unlikely to affect borrowing decisions. These legal provisions are a type of price term that consumers ignore, such that they function as hidden prices. In such a situation where borrowers do not price a potentially costly term, regulatory intervention is warranted.

Sixth, the regime would impose a licensing requirement for small-business lenders. Consumer lenders are generally required to be licensed, either on the state level, or via national banking or federal credit union charters. A small-business lending licensing regime would treat a federal or state banking or credit union charter as a sufficient license, but would then require other lenders to be licensed by the states, much as exists for money transmission or mortgage lender licensing.[331] At present, some states exempt all business loans from licensing laws, while others exempt only business loans over a certain size.[332] Given that states are already in the business of licensing consumer lenders and, in some cases, business lenders, this would not be a substantial imposition and would ensure an additional level of on-going regulatory oversight over small-business lenders.

Seventh, the proposed regulatory regime would define covered small-business financings to be a "consumer financial product or service," for purposes of the Consumer Financial Protection Act.[333] This would place covered small-business financings fully within the regulatory ambit of the Consumer Financial Protection Bureau ("CFPB") and its power to prohibit unfair, deceptive, and abusive acts or practices in connection with

330. *See generally* Jeff Sovern, Elayne E. Greenberg, Paul F. Kirgis & Yuxiang Liu, "*Whimsy Little Contracts" with Unexpected Consequences: An Empirical Analysis of Consumer Understanding of Arbitration Agreements*, 75 MD. L. REV. 1 (2015) (presenting survey results suggesting a "profound lack of understanding about the existence and effect of arbitration agreements among consumers"); Roseanna Sommers, *What do consumers understand about predispute arbitration agreements? an empirical investigation*, 19 PLOS ONE (Feb. 23, 2024) (finding that "less than 1% of [survey] respondents correctly understood the full significance of [arbitration agreements]"); Complaint at ¶¶ 65-67, CFPB v. Freedom Stores, Inc., No. 2:14-cv-643) (E.D. Va. Dec. 18, 2014) (arguing that consumers are unlikely to understand forum selection clauses).

331. *See* 18 U.S.C. § 1960 (2018) (criminalizing money transmission without a state license); 12 U.S.C. § 5103(a)(1) (2018).

332. *Compare* 17 ILL. COMP. STAT. § 670/21 (2021) (exempting entities making solely business loans from state lender licensing requirement) and R.I. GEN. L. § 19-14.1-10(b)(1) (2024) (exempting business loans from regulation, including licensing), *with* N.Y. BANKING L. § 340 (Consol. 2024) (requiring license for making loans of $25,000 or less to individuals for personal, family, household or investment purposes and for loans of $50,000 or less to for businesses) *and* 7 PA. STAT. ANN. §§ 6203 (2024) (requiring license for making loans of $25,000 or less).

333. 12 U.S.C. § 5481(5) (2018).

the offer of consumer financial products or services.[334] The CFPB already exercises jurisdiction over small-business lending through the Equal Credit Opportunity Act and Regulation B thereunder,[335] and public enforcement of the regulatory protections proposed for covered small-business financings is necessary given small-business borrowers' limited financial capacity for private enforcement.

It is important to emphasize what this Article does not propose. It does not propose extending the Fair Credit Reporting Act or the Fair Debt Collection Practices Act to small-business financings. The Fair Credit Reporting Act is not appropriate for business financings because, as noted above, the consumer credit reporting system simply does not translate to business credit due to the artificial nature of business entities. Likewise, the Fair Debt Collection Practices Act would be of little help to small businesses because it excludes most first-party debt collection—collection activity undertaken by the actual lender, which is the typical situation in small-business lending markets.

The regulatory reforms proposed by this Article are not costless, of course. Some of the proposed reforms would add some level of compliance costs, while the limitation on confessions of judgment and choice of law provisions would make it more difficult for lenders to collect from defaulted borrowers. The increased costs might in turn be passed along to borrowers in terms of higher prices or lower credit availability.

This is always the sort of trade-off that exists in consumer protection policy, with different legislatures reaching different conclusions. This Article does not take issue with what the particular trade-offs that have been made by legislatures. Instead, this Article's basic argument is that small-business financings are sufficiently similar to consumer financings that they should generally have the same regulatory treatment, whatever that particular treatment might be. In other words, concerns about the unintended consequences of increasing regulation of small-business lending are really concerns about the costs of consumer protection regulation writ large and do not go to the question of whether small-business lending should be treated differently from consumer lending. Whatever the regulatory treatment of consumer lending, small-business lending should be regulated in a substantially similar fashion.

Conclusion

Small businesses struggle to obtain credit because of information asymmetry issues and modeling problems that stem from their intense heterogeneity. These informational problems make it difficult for lenders to price small-business credit, particularly for small businesses that are

334. 12 U.S.C. §§ 5531, 5536 (2018).
335. 15 U.S.C. § 1691 *et seq.* (2018); 12 C.F.R. pt.1002 (2024).

new, very small, or risky—marginal small businesses. While collateral can overcome informational asymmetries in some instances, many small-business borrowers lack adequate collateral. The result is that such marginal small businesses often cannot get credit, and when they do, it is frequently on abusive terms with inadequate price disclosures, supracompetitive pricing, and abusive collection terms. In consumer credit markets these issues are addressed through regulation: credit cost disclosure requirements, usury laws, and prohibitions on collection practices. Small-business lending, however, is largely unregulated, leaving small businesses vulnerable to abuse.

American politicians across the political spectrum claim to support small businesses, which they present as the very salt of the earth and backbone of the American economy. Yet for all this rhetoric they have abandoned small businesses to rapacious market practices. It is time to adopt a comprehensive small-business credit regulatory regime that will ensure that small businesses can more readily obtain fair, transparent credit that enables them—and the American economy—to prosper.