

THE DOMINO EFFECT

By Paul A. Rianda, Esq.

I have been asking most all of my clients if the recent economic downturn has had any negative impact on their businesses and their residuals. For the most part the answer has been no, but with one important exception. The bad economy has caused a number of merchants in our industry to go out of business with corresponding significant chargebacks losses. These large chargeback losses, as will be explained below, can threaten your residuals, even if you did not originate the merchant that has the large chargeback liability. In this article, I will explain the risk that chargebacks can pose to your residuals and the ways to minimize that danger.

The First Domino: The Merchant Fails

The first domino that needs to fall is the merchant. In these tough times, many merchants are going out of business. Especially hard hit have been companies related to the housing market such as furniture stores as well as other types of companies like airlines. The issue as it relates to exposure to chargebacks with airlines and furniture stores is that those types of companies tend to take payment for the goods and services they offer months before they actually have to deliver the goods or services. If airlines, furniture stores or other similar businesses types go bust, there is the potential that customers will have paid for millions of dollars of purchases customers will not get due to the businesses' failure.

If an airline, furniture seller or other similar company that takes large deposits goes out of business, the usual result is a slew of chargebacks. All those persons that were lucky enough to pay by credit card (versus paying by check or with cash) are entitled to charge back the transactions to the merchant. The merchant, since it has gone out of business, will not have any cash to pay those chargebacks. The liability for those chargebacks goes up the line to the next liable party, which is typically an ISO that has agreed to take the risk of chargebacks.

The vast majority in number of people being paid residuals in this industry are feet on the street sales agents and ISOs that do not take risk. As a result of not taking risk, these parties may believe that a large chargeback, be it related to their portfolio or not, could not result in their residuals being terminated. The problem is that a chargeback that you as a sales agent or ISO are clearly not liable to pay under your agreement with your ISO could still result in the termination of your residuals.

The Second Domino: The ISO fails

The second domino that would potentially need to fall in order for you to lose your residuals is if your ISO or the processor above you were to fail. To continue the example from above, assume you are a feet on the street sales agent. You submit deals to your ISO and the ISO and you have agreed that you have no risk for chargebacks. But, assume that your ISO suffers a huge chargeback loss from a furniture store that goes out of business. Your ISO in its agreement with its processor and/or bank typically has a provision that states that if there is a large chargeback loss, that loss must be paid by the ISO to the card processor in a matter of days, if not immediately. If the ISO does not pay the chargeback loss in the required amount of time, the ISO has committed a breach of the ISOs agreement

with the processors and bank. Due to such a breach, the ISO will most likely lose the entire residual stream payable to the ISO forever.

In this example, you as the sales agent would also lose your residuals. The ISO would have its entire residual payment cut off, including the residuals that were paid to the ISO as a result of the merchants you had placed with the ISO. That is true even if you did not submit the merchant that caused the large chargeback. In essence, you are at risk, and potentially can have your residuals terminated because of the actions of any of the agents that work for the ISO you submit your merchants to for card processing.

How to Keep the Dominoes From Falling:

So how do you protect your residuals from being terminated through no fault of your own due to excessive chargebacks? One of the most important things I tell my clients is to try to make sure that you pick an ISO that is financially strong. That can take a number of different forms. One type of ISO that would be financially strong is generally one that is a public company or owned by a public company. Assuming the market capitalization of the company is of a decent size (in the hundreds of millions of dollars) you can usually assume that the company will be around for a long while. Also, you can check the profitability and balance sheet of a public company to verify its financial health to make sure it will not be negatively impacted by large chargeback losses.

Another way to measure financial health is to look at the number of merchants that the ISO you are dealing with has on its books. Most ISOs in their press releases and marketing materials will tout the number of merchants that they are processing for at any given time. It is usually a good rule of thumb that a company that has 100,000 merchants is going to be better off financially than one with 1,000 merchants. The larger merchant base means that the ISO will be generating more profits to pay for the potential chargeback losses and also will be able to spread out that loss over a much larger merchant base. It may also be prudent to see if the merchant base for the ISO is increasing over time by reviewing marketing materials and press releases from years past.

Another factor to consider is the underwriting criteria that is used by the ISO. You might find an ISO that has very lax underwriting criteria and you would probably be somewhat happy because the ISO would accept merchants that maybe other ISOs would not. But, with those lax underwriting standards, that means that the ISO is accepting high risk merchants not only from you, but also from many other agents. When an ISO takes on an inordinate amount of risk in this manner, it could result in that ISO going out of business due to excessive chargebacks and the resulting termination of your residuals.

Reputation in the industry is another important criteria to consider. Some ISOs are headed by industry veterans that have a history of running goods shops that have superior underwriting and risk management staffs. I find that most ISOs in our business have one key person that runs and owns the business. If you are able to find out about that person's reputation for honesty, integrity and intelligence in the industry, it is usually another good way to evaluate whether or not you should be sending business to the ISO.

I have touched upon a few of the ways to evaluate ISOs. None of these different criteria should be used individually to determine who should be your partner. You should use all of them in conjunction to make an informed decision about who you should partner with to minimize the risk of losing your residuals.

* Paul A. Rianda, Esq. is an attorney who has specialized in providing legal advice to the bankcard industry for over 10 years. For more information about this article or any other matters, please contact Mr. Rianda at (949) 261-7895 or via email at paul@riandalaw.com

** The information contained herein is for informational purposes only and should not be relied upon in reaching a conclusion in a particular area. The legal principles discussed herein were accurate at the time this article was authored but are subject to change. Please consult an attorney before making a decision using only the information provided in this article.