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THE UNITED STATES OF AMERICA



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Lawrence H. Brown
Secretary of the Treasury

TWENTY DOLLARS





PayPal is supposed to make buying and selling online easy and safe. But hundreds of angry customers say the e-payment service wrongfully froze their accounts, denying them access to their money. And instead of helping to solve these problems, users say, the company gave them the cold shoulder. Is that any way to treat a pal?

Left Out in the Cold

BY STEPHANIE WILLIAMS AND ELEANOR LAISE

PHOTOGRAPHS BY ZUBIN SHROFF

Jason LaLonde wanted to bake his own bread.

To do that, he needed a food processor to knead the dough, and as so many of us do these days, the 21-year-old Florida State University student went online to buy it. He found one that looked good on eBay and won the auction by bidding \$156.95. Bingo. LaLonde sent off the payment on Jan. 5 of this year, then sat back and waited for his food processor.

And waited. And waited. After a week or so, LaLonde logged back on to eBay. Judging from the online “feedback” left for the seller—who went by the name *garden_cook*—it seemed that other buyers were having problems too. “CAUTION,” one person had posted. “NONSHIPMENT! POSSIBLE FRAUD!”

Oh, great, LaLonde thought to himself. It's an Internet scam. This garden_cook is ripping me off. But he would soon discover that *garden_cook* wasn't the one giving him grief. Ironically, the problem lay with PayPal, the online-payment service whose sole purpose, as its Web site announces, is to make these transactions easy (“Pay anyone with an e-mail address”) and secure (“Trusted on over 3 million auctions”).

Every day more than 200,000 payments are sent over the Internet via PayPal. By comparison, Western Union processes 298,000 transactions a day. PayPal is now an option on 70 percent of eBay's auctions. Since PayPal's launch in October 1999, the company has signed up some 15 million users, more than any other e-payment system. Last year over \$3.5 billion was exchanged using PayPal, and in February the company staged the first successful Internet IPO in nearly a year. On its first day, the stock flew from its \$13 offering price to \$20.09; it now trades at around \$25.

But not everyone is so thrilled with PayPal. The company has a habit of “freezing” accounts, which means the owners can't access their funds. Lyle Kingsley of Seattle—aka *garden_cook*—says that's what happened to him, with no warning or explanation. Though the possibility of freezing is spelled out in the 28-page PayPal user agreement, hundreds of disgruntled customers say their money was locked up for no good reason and for unreasonable lengths of time. That prospect is scary enough, but it doesn't stop there. Some were devastated to find that their supposedly secure accounts had been raided by no-account Internet thieves. And as if scams and freezes don't produce enough gut-wrenching anxiety, distraught customers say trying to solve one of these PayPal problems can actually be worse. “Customer service,” they report, is a Kafkaesque nightmare of delays, stonewalling and bureaucratic hassles.

It's enough to make some former Pals want to sue. But as exasperated customers soon discover, they can't. According to that user agreement, customers can only go to arbitration. And that arbitration can happen in only one place: Santa Clara County, Calif. Some folks are angry enough to try their luck in court anyway; two class-action lawsuits were filed against the company

early this year. In the meantime consumers are flooding the Internet with their frustrations on sites such as [PayPalWarning.com](#) and [DoNotUsePayPal.com](#).

PayPal's vice president for communications, Vincent Sollitto, says the class-action lawsuits are “without merit” and that the company will “contest them vigorously.” Sollitto acknowledges that some customers have been inconvenienced but says “accounts are not frozen for no reason”; these measures are necessary to protect users against fraud. Sollitto says that PayPal is “a consumer-oriented success story,” pointing out that “we've got 15 million customers doing more than 200,000 transactions a day, the vast majority of which occur seamlessly and instantaneously at very low cost.” And in a January survey by Stamford, Conn., consulting firm Gartner, PayPal got a “highly trusted” rating from more consumers than any other e-payment system.

For those who've had the nonseamless experience, like LaLonde and Kingsley, that's not very comforting. Those two still don't know why their simple transaction got so bollixed up. Kingsley says that after his account was frozen in mid-December, he fought with PayPal customer service for a full month. Then his account was mysteriously “unrestricted.” A couple of scheduled payments went through, and then, as per its policy, PayPal distributed the remainder of his \$3,500 balance to the first few buyers who'd complained.

Problem was, Kingsley didn't know who had gotten paid and who hadn't. LaLonde didn't get his money back; he's trying to work it out with Kingsley directly. For LaLonde, the fiasco was “a pain, really aggravating.” But for Kingsley, the freeze had “a tremendous snowball effect.” The money to pay his suppliers was locked down, so they didn't ship him products, leaving his buyers empty-handed. But he couldn't refund their money, Kingsley says—it was stuck in his PayPal account. After some buyers protested, eBay shut Kingsley down, and he filed Chapter 13 bankruptcy for his small business. “I'm a successful businessperson, and this has screwed up my online credibility,” Kingsley says. “I was blindsided.”

Theoretically, using PayPal should be win-win, as simple as sending an e-mail. Let's say you owe \$20 to your brother Bob. You go to the PayPal Web site and set up an account using your e-mail address and a credit card or bank account. Then you send the cash by entering Bob's e-mail address. (This way you're protected if Bob gets greedy; he doesn't have your credit card number.) Bob gets an e-mail from PayPal saying his money is waiting, and he sets up a PayPal account to get paid. And if Bob wants to start selling baseball cards online and accept credit card payments, he can upgrade to a PayPal business account. PayPal will charge him a fee to receive payments: 2.9 percent of each transaction, plus 30 cents a pop.

PayPal has succeeded in part because the service sells itself. A PayPal user can send a payment to a nonuser, but the recipient must open a PayPal account to retrieve the funds. That's what they call "viral marketing." But that also means that when a problem such as a frozen account occurs, the sickness is contagious too. (For tips on exchanging money safely online, see "Safety Net: Buying Online," page 92.)

The way PayPal tells it, it was fraud that begot the freeze. As Sollitto admits, PayPal is "an attractive target for people with lots of stolen credit card numbers." A group of Russian hackers used stolen cards to open accounts in 2000, buying computers that they then sold in Kazakhstan. That was a wake-up call for PayPal. "We had to address it, or it would kill us," Sollitto says.

PayPal addressed the issue with a vengeance. The company developed antifraud software (dubbed "Igor" in honor of the Russian hackers), which flags suspicious activity in PayPal accounts. Those accounts are "restricted" or frozen. However, the threshold of suspicion can be low. Buying a \$1,000 stereo in an account that usually sticks to \$5 items, or linking your account to a free e-mail address such as Hotmail, are red flags that could lead to your account being iced. According to Dan Clements, president of online fraud watchdog CardCops.com, PayPal "freezes first, asks questions later. And the consumer is the one that suffers."

Why would PayPal be so quick to freeze? Sollitto says accounts can be frozen when chargebacks—credit card transactions that are reversed or denied—lead PayPal to suspect a seller of fraud. In those cases, he says, freezing "is both in PayPal's financial interest and the consumers' interest. But the main goal is to prevent buyers from being defrauded."

Clements maintains that another motive for freezing accounts is "keeping the chargeback rate down." He means that legally, PayPal is obliged to eat the losses from bad credit card transactions. If PayPal's chargeback rate gets too high, credit card companies can slap PayPal with hefty fines. Recently, MasterCard fined PayPal an undisclosed amount and threatened to withdraw its business unless PayPal reformed.

But some shocked customers warn that a frozen account isn't the only risk PayPal users run. Shannon Rafferty of Downey, Calif., says he woke up and checked his e-mail box on the morning of Jan. 29 to discover the PayPal account he thought was empty now showed a negative balance of \$7,000, including a \$2,000 charge to his Visa and checking accounts.

"I was horrified. I panicked," Rafferty says. According to Rafferty, a PayPal customer-service rep told him, "Don't worry.

We'll take care of everything," and promised someone would call within three hours. That call never came, Rafferty claims. He canceled the Visa and stopped the bank transactions, but couldn't remove the negative PayPal balance. "I phoned a half dozen times and spoke to people who, with varying degrees of rudeness, always told me there was nothing they could do," Rafferty says.

PayPal won't comment on individual cases, but Sollitto contends that customers with problems like Rafferty's represent a "minute percentage" of PayPal customers. "For all of 2001, our fraud loss rate was less than one-half of a percent," he says. "That's a tremendous accomplishment."

Jody Lewis isn't exactly awed by PayPal's accomplishments. The part-time sports memorabilia dealer in Bellevue, Wash., had his account frozen last November, after he tried to transfer a \$7,300 payment for a baseball bat used by Ichiro Suzuki into his checking account. In the next month, Lewis grew increasingly



irate as PayPal reps answered his pleading e-mails with form letters. Three times he faxed over documents requested by PayPal. "I would comply, comply, comply, and weeks would go by," says a frustrated Lewis. "And I'd call again and get the run-around." After contacting PayPal's lawyer, Lewis got his account unfrozen in mid-December. But he estimates that the debacle cost him an estimated \$40,000 in holiday sales.

Dealing with PayPal customer service, Lewis and others say, can be just as maddening as having your account frozen. Most PayPal users, buyers who use the service for free, must file com-

safety net: buying online

plaints through an online form or search the user agreement for the long-distance service number (where waits on hold can last an hour and a half). Only business customers, who pay for their accounts and make up about 20 percent of PayPal's clientele, are given a toll-free number—but they're not really supposed to call either. "We encourage all customers to contact us by Web form," Sollitto says, "so we can serve them efficiently and cost-effectively."

This Web form, detractors charge, elicits only non sequiturs or cookie-cutter responses that have little bearing on customers' actual concerns. Among those who do get to speak to a rep, some complain that they are asked to jump through a maddening series of bureaucratic hoops. Or the reps simply give them a live-body version of the Web form: "It's like talking to a child," says Shannon Rafferty. "They have this script, and that's all they will say."

Sollitto vigorously defends PayPal's customer service. "We take criticism from customers very seriously," he says. "The vast majority of our services we've developed at the direct behest of our customer base. We've succeeded because we're responsive."

Seventy percent of all eBay auctions offer PayPal, but buyers and sellers with PayPal problems shouldn't bother asking the auction site for help. Even though rumors have swirled that eBay was in talks to buy PayPal, eBay maintains a very hands-off approach. "It's not eBay that freezes the accounts, it's PayPal," says eBay spokesman Kevin Pursglove. (Both companies declined to comment on a possible sale.)

This lack of recourse leaves some folks thinking lawsuit. But Section II, Item 19 of the user agreement, the infamous arbitration clause, stipulates that consumers who have a dispute with the company can't sue PayPal. And as Wilkes-Barre, Pa., lawyer Richard Manning found out, that clause can be ironclad. His saga began with a \$10 overpayment to his small antiques business. Manning's attempts to reimburse the \$10 led to the freezing of his PayPal account, which led him to file a lawsuit, Item 19 notwithstanding. But the Pennsylvania court upheld the user agreement—he'd have to go to Santa Clara County for arbitration. Seventy-seven years old and facing serious health problems, Manning packed it in. "Every guy that has a \$25 argument with them has to go to California," he says. "You can't trust someone like that."

His experience suggests that the two recently filed class-action suits might be lost causes. But Eric Gibbs, the lead partner on one of the cases, believes California law will be more favorable to his clients. Meanwhile, consumers continue to cast about for someone to hold PayPal accountable. The sticky question is: Who's overseeing this business? Since PayPal customers can have their funds placed in FDIC-insured accounts, and they're offered a money-market fund and ATM debit cards, PayPal walks and talks like a bank. But it's not regulated as a bank. "We're not holding funds," Sollitto says. "And we don't make loans." PayPal now has money-trans-

SO PAYPAL ISN'T ALWAYS YOUR BEST BUDDY.

If you're still itching to buy that first-edition Faulkner online and don't want to hand over your credit card info to some unknown seller (or he doesn't take cards), you have several other options. Here's how they stack up:

- **eBay Payments** (formerly known as Billpoint) is a good alternative for online auctions. Buyers who use the system will be reimbursed up to \$175 if they're sent damaged goods—or no goods at all. It's free for buyers; sellers pay 35 cents plus 1.5 percent of any amount over \$15. The downside: This system is available only to eBay users.
- For non-eBay auctions, Yahoo!'s **PayDirect** costs 30 cents plus 2.5 percent of each transaction and requires a "security key" (similar to a PIN number) in addition to an ID and password to access an account. One drawback: Buyers and sellers have to haggle over who pays the fee.
- If you're willing to sacrifice speed for some extra security, try Western Union's **BidPay**. Buyers pay with a Western Union money order—sent out by snail mail. The service costs \$3 to \$5, depending on the order size, plus 2.25 percent of the transaction amount for orders over \$100. But you can't send more than \$700.
- Having doubts about an online merchant? The U.S. Postal Service's **Send Money** offers some reassurance. Have purchases sent by Priority Mail and the Pay@Delivery feature will release your money to the seller only after the package hits your doorstep. And it costs just \$1 per transaction.
- When you need to send money internationally, Citigroup's **c2it** e-payment service is the best bet. Users can send payments to over 100 countries for a flat fee of \$10. Domestically, c2it is free to both buyers and sellers—and you don't need a Citibank account to use the system. Plus, if you discover fraudulent activity in your c2it account and notify the company within two days, you're not liable for any unauthorized transactions over \$50. —E.L.

mitter licenses, like those Western Union holds, in seven states. So customers with PayPal problems there can appeal to their state's department of finance.

Where does this leave the rest of PayPal's disgruntled customers? Disgruntled, mostly. And when disputes do get resolved or frozen accounts thaw, these users report, it's just as unpredictable and arbitrary as the problems themselves. Jason LaLonde had given up on getting his food processor money refunded when he heard from PayPal customer service, six weeks after he'd won the auction. He was thrilled to see a message appear in his e-mail box titled "Resolution of Buyer Complaint Case #329822." "We are pleased to inform you that we were able to recover funds from the seller's account," the e-mail said. LaLonde read on, eager to find out when he'd get his \$156.95 back. The next line said it all: "Your account has been credited \$0.02." 