Pepper Hamilton LLP
Attorneys at Law

MCA Participations and Security Laws: Recognizing and Managing a Looming Threat

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Gregory J. Nowak | nowakg@pepperlaw.com
Mark T. Dabertin | dabertinm@pepperlaw.com

Due to the high volume of relevant judicial decisions issued by New York courts over the past two years, the risk that enforceability of a merchant cash advance (MCA) contract[1] might be successfully challenged as a disguised usurious loan has received ample attention in law firm white papers and published legal articles, including articles by Pepper Hamilton attorneys.[2] Avoiding this risk of "loan re-characterization" is essential if the MCA industry is to achieve wider acceptance as a source of small business financing. But another risk—which we believe is largely unrecognized—could significantly throttle further expansion of MCA financing. This risk is that the funding structures MCA providers rely on to generate funding from third-party investors could be found to involve the issuance of unregistered securities. Unless an exception is available, that would be unlawful and could result in fines, penalties, defense costs and even rescission of the entire transaction, with the "issuer" being required to return investor capital.

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Many MCA providers raise new funding by offering "participation interests" in their MCA contracts to third-party investors. These are usually structured in one of two ways. Under a "true participation," the participant acquires the right to receive payments, and a resulting return on the participant's investment, exclusively from the MCA provider. To this end, the participant receives no rights to enforce, nor any direct interest in, the underlying MCA contracts. Alternatively, the participation agreement may be structured so as to make each investor a pro rata "co-funder" of the underlying MCA contracts in an agreed-upon percentage (the "participation share"). Under this structure, the MCA provider's contract with the merchant typically acknowledges the possible existence of "co-funders" in general terms, and does not require the merchant to ratify and accept named co-funders as they come into being. This add-on is usually accomplished through a novation to the MCA contract.

Under either of the above-described participation structures, the nature of the participant's investment is purely passive, with no possibility for active involvement in the underlying MCA relationships. In fact, the participation agreement likely expressly prohibits such interference. The passive nature of a participant's investment matters, because the presence of passivity, and the resulting reliance on the efforts of another party (i.e., the party offering the investment) to realize a profitable return, is a key factor for purposes of determining whether a security exists under the federal securities laws.

In *SEC v. WJ Howey Co.*,[3]> the U.S. Supreme Court established the following four-factor test for identifying the existence of a security: (1) an investment, (2) in a common enterprise, (3) with a reasonable expectation of profits, (4) to be derived from the entrepreneurial or managerial efforts of others. The facts of *Howey* concerned investments in an orange grove operation, where the investors were entirely dependent on the efforts of the orange grove manager/promoter to maintain the trees that the investor had invested in. In the case of an MCA participation structured as described above, all four *Howey* factors are arguably present. An investment is made with the expectation of realizing a profit. In addition, as discussed above, because that investment is passive in nature, its success hinges on the efforts of the MCA provider. Finally, at least one court has opined that the existence of common enterprise is inherent to any participation relationship.[4]

The *Howey* test, which seeks to identify the presence of an "investment contract," is not the sole means for evaluating whether an investment constitutes a security. In *Reves v. Ernst & Young,* the U.S. Supreme Court recognized that the expansive definition of the

term “security” under the Securities Act of 1933 and the Security Exchange Act of 1934 extends to other forms of “notes” besides investment contracts.[5] In determining whether the “demand notes” at issue in *Reves* constituted a security, the court applied what is commonly known as the “close resemblance” test. Under this test, if the note in question bears a close resemblance to a type of note that has been judicially recognized as not involving a security, that note likewise will not be considered a security. For example, on its face, an MCA contract closely resembles “a short-term note secured by a lien on a small business or some of its assets.”[6] However, in an MCA contract, the purchased future receivables provide the source of repayment of the advanced funds, as opposed to providing security for a lien.

This distinction is important. because in an MCA, the receivables do not yet exist, so there is nothing to lien. Rather, the MCA involves receivables to be created, presumably using the proceeds of the MCA to do so. Properly drafted MCAs sidestep all “note-like” characteristics, and make it clear that the MCA is a contract to purchase an asset (i.e., receivables) that are yet to be created. There is no sum certain for repayment – unlike a note, if the receivables turn out to be bad, the MCA provider has no recourse back to the merchant that created them. The receivables are not security for a loan; rather, the receivables are the property being forward purchased. MCAs are different in kind and extent from loans.

Notwithstanding the *Howey* test, and as noted above, it is possible to argue persuasively that an instrument that appears to be a security instead describes the terms of an individually negotiated contractual agreement. In this regard, in *Marine Bank v. Weaver,*[7] the U.S. Supreme Court held that a contract between a bank and a married couple that called for the latter to pledge a certificate of deposit as security for a loan between the bank and an unrelated corporate borrower in exchange for the opportunity to share in the latter’s future profits did not involve a security. In doing so, the court distinguished the note in question from investments that fall within the “ordinary concept of a security. . . [which are offered] to a number of potential investors.”[8] In contrast, the Court in *Marine Bank* found that the contested note created “a unique agreement [that was] negotiated one-on-one by the parties” and was therefore, “not a security.”[9]

In the absence of an applicable statutory exemption, the public offering of unregistered securities constitutes a criminal violation of the federal securities laws. Because securities can generally only be sold to the public by a registered broker-dealer, people who engage in selling such securities, as well as their related corporate actors, may be

subject to monetary penalties for the resulting violations of law. An improperly structured MCA participation presents the risks that: (i) sales of participations made under the flawed structure could be declared void and subject to rescission; and (ii) both the MCA provider and its primary individual actors could be subject to criminal prosecution and resulting monetary penalties. In the remainder of this article, we discuss ways for effectively mitigating these risks.

Structuring the MCA participation so as to make each participant not merely a “co-funder” in name, but an *actual* party to each underlying MCA contract by means of a contract novation signed by the merchant and naming the individual participants, would arguably eliminate any risk that the structure might be deemed to involve the unlawful issuance of securities. Under this structure, each participant, at least in theory, could enforce the MCA contracts directly against the applicable merchants, without having to rely on the MCA provider. The main flaw with this option is that the MCA participation agreement necessarily prohibits such independent actions by the participant, because those actions could directly conflict with the economic interests of either or both the MCA provider or additional participants. Hence, any actual ability of the participant to be actively engaged in the underlying merchant relationships will be missing. As the number of participants increases to more than a handful, this structure – requiring as it does that the merchant ratify and accept every new participant as each participant is added, is unwieldy and becomes infeasible to administer.

One could also argue that including a requirement in the MCA participation agreements that the participant must evaluate independently the quality of each MCA contract before the purchase of the participation share precludes the existence of a common enterprise. However, unless each participant has its own series of MCAs, this distinction is unlikely to be of significance, because all participants are participating in the *same* MCA. Also, notwithstanding the obligation to conduct independent reviews, the MCA participant must still rely on the MCA provider to source qualified merchants. In addition, as noted above, the investor also must depend on the MCA provider’s success in collecting payments from merchants, which will determine whether a profitable return is achieved. Finally, where a pool of investors all share in the risks and benefits of a particular business enterprise (known in securities law as “horizontal commonality”), the resulting presumption of a common enterprise is extremely difficult to disprove.

In view of the above, we suggest that the best way to manage the risk that the participation structure might be viewed as involving the unauthorized issuance of securities is to embrace the substance, if not the precise letter, of the federal securities

laws. Specifically, by structuring the participation in a manner that complies with the safe harbor from the requirement to register securities described in Section 506 of the SEC rules under the Securities Act of 1933. This entails: (i) only selling participations to accredited investors; (ii) describing the applicable risks (i.e., the risk factors) and potential conflicts of interest in an addendum to the participation agreement; (iii) making sure that all sales of participants are made on a one-to-one basis, with no general solicitation or marketing; and (iv) advising participants that the resale of their participation share may be subject to a one-year minimum holding period. (Of course, if the MCA pays off before the one year period and extinguishes the MCA, that is not an issue under this rule.)

We caution that the securities laws are both difficult to navigate and prone to divergent interpretations. The consequences of misinterpretation can be severe and could result in the rescission of existing participations and monetary penalties. Hence, this is not a DIY proposition.

Pepper Points

- The risk that an MCA participation structure could be found by a regulator or court to constitute the unlawful issuance of securities is under appreciated, and has serious consequences that could throttle the availability and growth of MCA financing.

- Although legal arguments can be made in support of the position that the most commonly used MCA participation structures do not involve the unlawful issuance of unregistered securities, none of those arguments is sufficiently persuasive to preclude the need for additional risk mitigation efforts.

- Mitigation plans for managing the risk that a given MCA participation structure involves should incorporate complying with the substance, and the precise letter, of the federal securities laws.

The federal securities laws are difficult to navigate and prone to divergent interpretations. The consequences of misinterpretation are severe and could include the rescission of existing participations and assessments of monetary penalties, including against individual actors.

Endnotes

1 An MCA is a business financing option that involves the advance of funds to a merchant, typically to assist the merchant in managing its short-term cash flow needs, in exchange for the sale of a specified percentage of the merchant's future receivables at a sizeable discount. It is a relatively new offshoot of "factoring," which likewise involves the purchase and sale of receivables at a discount in exchange for an advance of funds to a business, with the primary difference being that the receivables in the case of MCA financing are not yet extant. An MCA contract might be deemed a disguised usurious loan for many reasons, including the inclusion of a set term within which the advance must be repaid in full to avoid default. The most critical factor in this regard is whether the MCA provider is looking to the purchased receivables for repayment, or to the merchant itself or its individual owner(s); e.g., in the form of a financial guarantee given by the owner(s).

2 For a broader discussion of MCA financing, and the risk of re-characterization as a usurious loan, see: https://www.pepperlaw.com/publications/recent-litigation-illustrates-why-merchant-cash-advances-are-not-loans-2017-04-20/.

3 328 U.S. 293 (1946).

4 *Provident National Bank v. Frankfort Trust Co.*, 468 F. Supp. 448, 454 (E.D. Pa. 1979) (By its "very nature" any participation involves a common enterprise.).

5 494 U.S. 56, 64 (1990) ("The demand notes here may well not be 'investment contracts,' but that does not mean they are 'notes.' To hold that a 'note' is not a 'security' unless it meets a test designed for an entirely different variety of instrument 'would make the Acts' enumeration of many types of instruments superfluous' *Landreth Timber*, 471 U.S. at 692, and would be inconsistent with Congress' intent to regulate the entire body of instruments sold as investments, see supra at 60-62".).

6 *Id.* at 65.

7 455 U.S. 551 (1982).

8 *Id.* at 552.

9 *Id.*at 560. In *Vorrius v. Harvey,* 570 F. Supp. 537, 541 (S.D.N.Y. 1983), the court followed *Marine Bank* in finding that a contested loan participation agreement involved an individually negotiated contract versus a security. A key factor in that case, however, was the existence of a comprehensive federal regulatory scheme apart from the federal securities laws in the form of banking laws and regulations, which made application of the former unnecessary for purposes of protecting the interest of investors. No such alternative regulatory scheme exists in the case of the MCA industry, which is generally unregulated.