

INVESTMENT MANAGEMENT AND PRIVATE FUNDS  
What's Happening Now?

# Structuring and Funding MCA Agreements

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# What is Merchant Cash Advance?

Merchant Cash Advance is a specialized form of accounts receivables factoring.

- ▶ “Factoring is a financial transaction and a type of debtor finance in which a business sells its accounts receivable (i.e., invoices) to a third party (called a factor) at a discount. A business will sometimes factor its receivable assets to meet its present and immediate cash needs.” [Wikipedia](#).
- ▶ “Purchases and sales of future receivables and sales proceeds are common commercial transactions expressly contemplated by the Uniform Commercial Code.” [IBIS Capital Group, LLC v Four Paws Orlando LLC](#), 2017 N.Y. Misc. LEXIS 884, 2017 NY Slip Op 30477(U), \*6 (N.Y. Sup. Ct. Mar. 10, 2017).

# What is Merchant Cash Advance?

If appropriately structured, Merchant Cash Advance is not a loan.

‘The rudimentary element of usury is the existence of a loan or forbearance of money’ [cites omitted]. . . ‘When determining whether a transaction constitutes a usurious loan it must be ‘considered in its totality and judged by its real character, rather than by the name, color, or form which the parties have seen fit to give it.’ [cites omitted]. ‘Whether a transaction constitutes a cover for usury is a question of fact.’ [cite omitted]. . .

‘Further, there can be no usury unless the principal sum advanced is repayable absolutely.’

*Colonial Funding Network, Inc. v. Epazz, Inc.*, 2017 U.S. Dist. LEXIS 70747, \*7.

# NY Courts Have Adopted Rules for Sorting MCAs from Loans

*LG Funding, LLC v Snowstar, Inc.*, 2017 N.Y. Misc. LEXIS 5190, 2017 NY Slip Op 32741(U) (N.Y. Sup. Ct. Dec. 7, 2017)

## Analysis

- Court denied Plaintiff Snowstar’s motion for summary judgment based on two 2017 New York Supreme Court cases: *K9 Bytes, Inc. v. Arch Capital Group* and *IBIS Capital Group, LLC v. Four Paws*.
- Citing *K9 Bytes*, the court identified three factors as determinative the MCA agreement created a loan: (1) whether principal was “put in hazard” versus “in some way secured;” (2) existence of a reconciliation provision; and (3) an indefinite versus a fixed repayment term.
- The agreement described a “purchase and sale;” there was no promissory note or repayment schedule; and the personal guarantees of performance were no broader than the merchant’s obligations (i.e., no payment shortfall coverage).

# Recent MCA Cases

*LG Funding, LLC v Branson Gateways, Inc.*, 2017 N.Y. Misc. LEXIS 4381, 2017 NY Slip Op 32387(U) (N.Y. Sup. Ct. November 13, 2017)

## Facts

- Branson was seeking to overturn the grant of a default judgment in favor of LG Funding.
- LG had obtained the default judgment after Branson stopped paying.
- The disputed MCA agreement contained similar terms to those at issue in *LG Funding, LLC v Snowstar, Inc.*
- Branson's principal owner had executed a personal guarantee of performance covering the "terms and conditions by Branson in the Agreement."
- "Defendants had the opportunity to review all pages of the Agreement."

# Recent MCA Cases

*LG Funding, LLC v Branson Gateways, Inc.*, 2017 N.Y. Misc. LEXIS 4381, 2017 NY Slip Op 32387(U) (N.Y. Sup. Ct. November 13, 2017)

## Analysis

“The Agreement . . . does not fall under the exception of being [a] disguised loan because the payment to Plaintiff is based on the receivables earned by the merchant. If the merchant would not make any money, then Plaintiff would not be entitled to any money. And if the merchant would only make a small amount of money, the Plaintiff would only be entitled to a small amount of money based on the percentage set forth in the Agreement.”

The court further noted that on a number of occasions, LG exercised forbearance and took less than the maximum amount of collected receipts it was authorized to take.

# Additional Factors

- ▶ Whether the merchant's filing for bankruptcy constitutes a default. *IBIS Capital Group, LLC v Four Paws Orlando LLC*, 2017 N.Y. Misc. LEXIS 884, 2017 NY Slip Op 30477(U), \*7 - \*9 (N.Y. Sup. Ct. Mar. 10, 2017).
- ▶ Confession of Judgment (“COJ”) – New York case law (up to the Appellate Court level) has been favorable, but a recent Bloomberg News investigation created awful publicity, and Bloomberg reports that New York Democrats are considering outlawing the practice.
- ▶ Whether the agreement is drafted in understandable terms. *K9 Bytes, Inc. v Arch Capital Funding, LLC*, 2017 N.Y. Misc. LEXIS 1903, 2017 NY Slip Op 27166 (N.Y. Sup. Ct. May 4, 2017).
- ▶ Requiring additional collateral unrelated to the receivables coupled with “hair trigger” default provisions.

# Additional Factors

- ▶ Whether the agreement has finite term. A finite term is consistent with a loan. An indefinite term “is consistent with the contingent nature of each and every collection of future sales proceeds under the contract.”
- ▶ Whether the merchant’s filing for bankruptcy constitutes a default. *IBIS Capital Group, LLC v Four Paws Orlando LLC*, 2017 N.Y. Misc. LEXIS 884, 2017 NY Slip Op 30477(U), \*7 - \*9 (N.Y. Sup. Ct. Mar. 10, 2017).
- ▶ Confession of Judgment – New York case law has been favorable, but a recent Bloomberg News Investigation created terrible publicity, and Bloomberg reports that New York Democrats are seeking to outlaw the practice.
- ▶ Whether the agreement drafted in readable language. *K9 Bytes, Inc. v. Arch Capital Funding, LLC*, 2017 N.Y. Misc. LEXIS 1903, 2017 NY Slip Op 27166 (N.Y. Sup. Ct. May 4, 2017).
- ▶ Additional collateral beyond the receivables coupled with “hair trigger” default provisions.

# Additional Factors

Bad facts can undermine a well-drafted MCA.

- ▶ *Pearl Capital Ravis Ventures, LLC v RDN Constr., Inc.*, 54 Misc. 3d 470, 41 N.Y.S.3d 397, 2016 N.Y. Misc. LEXIS 3945, 2016 NY Slip Op 26344 (N.Y. Sup. Ct. Oct. 25, 2016) (In testimony plaintiff's Chief Risk Officer was unable to describe a single example of a situation in which plaintiff would face the non-recourse risk of non-payment).
- ▶ *Bistro Executive, Inc. v. Rewards Network, Inc.*, 2006 U.S. Dist. LEXIS 100770, 2006 WL 6849825 (C.D. Cal. July 18, 2006) (Plaintiff's policies, procedures, and job descriptions were identical to, and indistinguishable from, those of a traditional lender).

# Courts in Other Jurisdictions May Not Honor New York Law

*Saturn Funding, LLC v. NRO Boston, LLC*, No. CV 16-2523B, 2017 WL 836547, (Mass. Super. Feb. 21, 2017). Court.

Court found the contested MCA agreement's choice of law clause invalid where "the agreements were executed in Massachusetts, by Massachusetts residents and Massachusetts businesses, through a Massachusetts notary" and refused to recognize a confession of judgment obtained in New York. The court then found, without undertaking a detailed analysis of the contract's terms: "[h]aving now reviewed the documents defendants provide, the Merchant Agreement appears to be at a usurious interest rate."

Include an arbitration clause choosing New York law.

# Bad Facts Can Trump a Well-Drafted MCA

- ▶ *Pearl Capital Rivis Ventures, LLC v RDN Constr., Inc.*, 54 Misc. 3d 470, 41 N.Y.S.3d 397, 2016 N.Y. Misc. LEXIS 3945, 2016 NY Slip Op 26344 (N.Y. Sup. Ct. Oct. 25, 2016)(In testimony plaintiff's Chief Risk Officer was unable to describe a single example of a situation in which plaintiff would face the non-recourse risk of non-payment).
- ▶ *Bistro Executive, Inc. v. Rewards Network, Inc.*, 2006 U.S. Dist. LEXIS 100770, 2006 WL 6849825 (C.D. Cal. July 18, 2006)(Plaintiff's policies, procedures, and job descriptions were indistinguishable from those of a traditional lender).

# MCA Participations and Securities Law

1. Why is this important?
2. You represent whom?
3. You must respect (fear?) Section 29 of the Securities Exchange Act of 1934, as amended.

# What is a Syndication?

- ▶ Debts issued by a consortium of lenders to a sole borrower.
- ▶ There is a “lead lender” or arranger for each consortium.
  - Lead is responsible for facilitation of the loan and allocating cash flows to the other consortium members.
    1. Underwritten deal
    2. Club deal
    3. Best-Efforts Syndication Deal

# Partnership?

- ▶ '40 Act issues and Advisers Act Issues?
- ▶ Tax Issues
- ▶ Does holder have debt or equity?
- ▶ Who has custody of the assets? Do they have legal competence?

# Participation?

2.4. The Participant shall have no interest in any property taken as collateral for any other loans or extensions of credit made to or for the Borrower by Lender, or in any property in the possession or control of Lender, or in any deposit held or other indebtedness owing by Lender, which may be or become available for payment of the Advances by reason of the general description of secured obligations contained in any security agreement or other agreement or instrument held by Lender or by reason of the right of set-off, counterclaim or otherwise, except that if such property, deposit or indebtedness or the proceeds thereof shall be applied in reduction of the amount of Advances outstanding under the Loan Agreement then the Participant shall be entitled to its proportionate share in such application.

# Participation?

2.5. If Participant shall obtain any payment (whether voluntary, involuntary, through the exercise of any right of banker's lien, set-off, or counterclaim) on account of Participant's Participation in the Advances in excess of Participant's Participation Percentage of such payment on account of the Advances, Participant shall purchase from Lender and such other persons or entities to which Lender shall have sold Participations in the Advances (such other persons and entities, together with Participant and Lender, being referred to as "Participating Entities") such additional participation in the Advances as shall be necessary to cause Participant to share such excess payment ratably with the Participating Entities, provided that if all or any portion of such excess payment is thereafter recovered from Participant, such purchase shall be rescinded and the purchase price restored to the extent of such recovery (but without interest).

# What is a Participation?

“Participations are not loans; they are contractual arrangements between a lender and a third party, in which the third party, or participant, provides funds to the lender. The lender in turn uses the funds from the participant to make loans to the borrower.” . . . . If the agreements are “true participations,” [citations omitted] and thus sales rather than loans, then the funds are effectively removed from the res. of the estate.”

*Rothenberg v. Oak Rock Fin., LLC*, 14-cv-3700, USDC, EDNY (March 31, 2015).

# Elements of a Participation

1. Money is advanced by participant to a lead lender;
2. A participant's right to repayment only arises when a lead lender is paid;
3. Only the lead lender can seek legal recourse against the borrower; and
4. The document is evidence of the parties' true intentions.

*Rothenberg.*

# Factors that Signify a Debtor Creditor Relationship

1. Guarantee of repayment by the lead lender to a participant;
2. Participation that lasts for a shorter or longer term than the underlying obligation;
3. Different payment arrangements between borrower and lead lender and lead lender and participant; and
4. Discrepancy between the interest rate due on the underlying note and interest rate specified in the participation.

# Participation or Loan?

“The most determinative factor of all of these is the risk allocation involved in the transaction. If the participant does not bear the same risk of loss as the seller, or if the seller has made a guarantee of payment to the participant, the transaction [\*28] is generally considered a loan and not a sale.” *In re Corporate Financing, Inc.*, 221 BR. 671 (Bankr. E.D.N. Y. 1998). “In a typical participation agreement, the lead lender makes no warranties or guarantees about the borrower's ability to repay the underlying loan. Thus, an indicium of a loan is the guarantee of repayment by the lead lender to a participant.” *In re Sackman Mortgage Com.*, 158 B.R. at 933.

# Participation or Loan?

Where an investor receives “no contractual guarantee of repayment or compensation” in the case of the borrower’s default, “[s]uch assumption [\*39] of risk strongly suggests that the [investors [are] not in a creditor-debtor relationship with [Lender].”

*In re Golden Plan of California, Inc.*, 829 F.2d at 709-10.

# What is a Security?

- ▶ Howey test
  - investment of money
  - in a common enterprise
  - with the expectation of profit
  - from the efforts of others



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- ▶ Concentrates his practice in securities law, particularly in representing investment management companies and other clients on matters arising under the Investment Company Act of 1940.
- ▶ Represents many hedge funds and other alternative investment funds in fund formation and investment and compliance matters, including compliance audits and preparation work.
- ▶ Writes and speaks frequently on issues involving investment management, health care and other matters. Mr. Nowak is the author of five books on hedge funds.



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- ▶ Has more than 25 years of broad-based experience in financial services law and regulatory compliance.
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- ▶ Works in regulatory compliance at large financial institutions has been marked by innovations that resulted in fundamental structural changes to existing firm-wide compliance activities, including with respect to regulatory change management, risk assessments, and vendor management.
- ▶ Frequently handles the negotiation of agreements between non-bank lenders and regulated banks, and has represented both banks and non-bank parties to such relationships.

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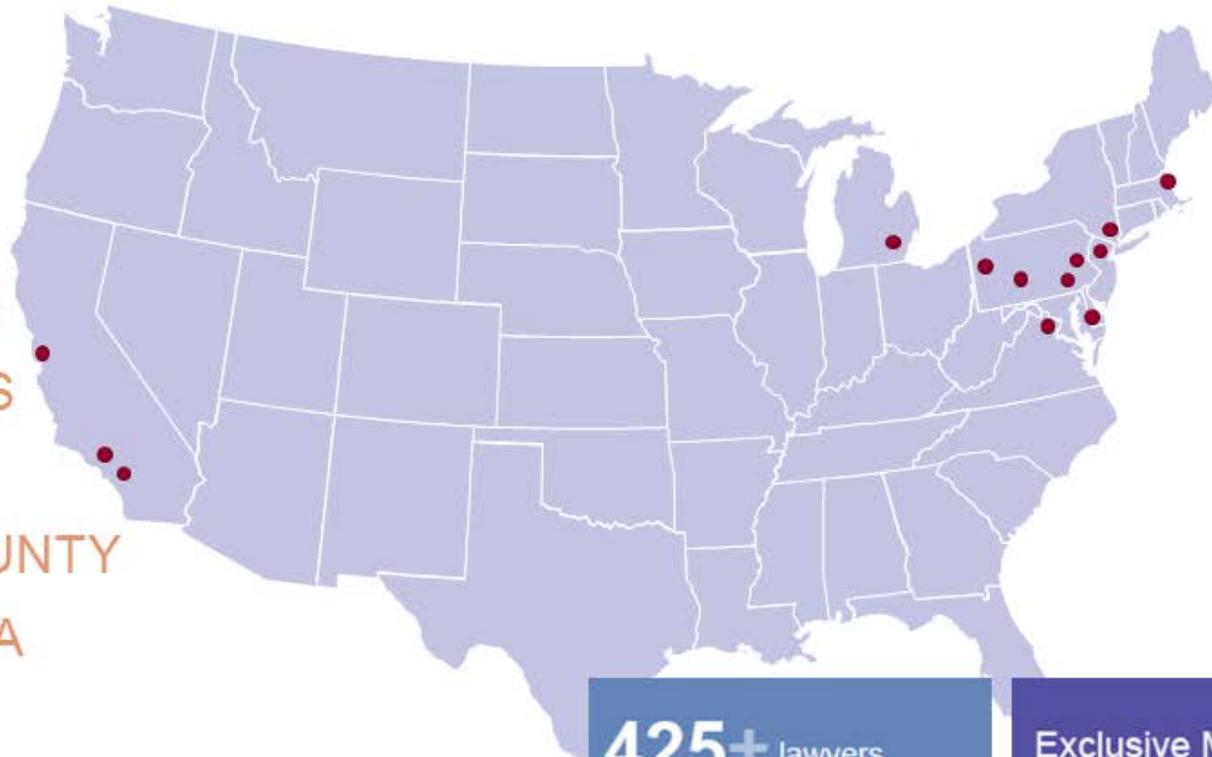
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