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Bankruptcy Recourse in MCA Agreements

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In preparing a merchant cash advance (MCA) agreement on behalf of the provider, there is constant tension between the urge to include every conceivable contractual right for protecting the provider's economic interests and the need to avoid language that might reorder the parties' relationship in a way that renders the entire agreement unenforceable. Deciding how to address the possibility that the merchant might pursue bankruptcy poses a particularly challenging dilemma. On the one hand, bankruptcy may diminish—if not defeat—the provider's chances for obtaining a profitable recovery of its investment. On the other hand, the concept of an *investment* in future receivables necessarily envisions a willingness to accept normal business risks, including the risk of the merchant's failure. This article explores how New York courts have treated bankruptcy-related recourse in considering the loan status of MCA agreements, and concludes with some helpful suggestions.

In *K9 Bytes, Inc. v. Arch Capital Funding*,[1] which was decided in May 2017, the Supreme Court of New York, Westchester County noted that New York trial courts have examined many MCA agreements over the past several years and "have largely determined that most of them are not loans, but purchases of receivables." The court elaborated that in reading through those decisions, "there are certain factors that a court should look for to see if repayment is absolute or contingent."[2] In particular, the court identified three "quintessential factors" that should be present in any MCA agreement: (1) a reconciliation provision that allows the merchant adjust its stipulated daily payments to the amount of its actual daily receipts; (2) an indefinite contract term, which is "consistent with the contingent nature of each and every collection of future sales. . .;"[3] and (3) whether the provider has recourse if the merchant declares bankruptcy.[4]

In evaluating the relevance of bankruptcy recourse provisions, the *K9 Bytes* court noted that just two months earlier in *IBIS Capital Group, LLC v Four Paws Orlando LLC*,[5] the Supreme Court of New York, Nassau County had cited an MCA agreement's failure to provide recourse for bankruptcy, along with other factors, in finding the subject agreement "wholly contingent [in] nature."[6] Although one of the two MCA agreements before the court in *K9 Bytes* expressly provided for recourse in the event of the merchant's bankruptcy filing, and the other allowed the merchant's personal guarantee to be enforced in such event, the *K9 Bytes* court did not treat such recourse as dispositive. With respect to defendant Arch Funding, the court concluded its analysis as follows:

> Having weighed all of the factors, the Court finds that the Arch agreements are sufficiently risky such that they cannot be considered loans, as a matter of law. Under no circumstances could Arch be assured of repayment, because its agreements are contingent on a merchant's success, and the term is indefinite. Accordingly, the Court dismisses the usury claims against Arch in their entirety.[7]

Additionally, at least one bankruptcy court has looked to similar factors when deciding a MCA company's rights in purchased future receivables after a merchant declared bankruptcy.[8] That court looked to eight factors[9]—focusing which party bore the risk of non-collection from the account debtor—to determine whether the transaction was a true sale. The court did not consider any individual factor to be conclusive but did expressly examine that the MCA agreement was non-recourse even if the merchant ceased operations, noting that the "only circumstance under which [the MCA company] would have rights against [the merchant] occur[ed] upon an affirmative act by the [merchant] which impair[ed] [the MCA company's] rights in the acquired assets, such as a subsequent sale or granting of a lien on the purchased Accounts."[10]

Because the merchant retained no rights in the purchased accounts, proceeds being collected by the merchant during bankruptcy in connection with those accounts were not "cash collateral," but instead were property of the MCA company that the merchant was improperly converting. The court therefore ordered the merchant to use a credit card processor acceptable to the merchant cash advance company under the terms of the MCA agreement and directed the credit card processor to turn over purchased accounts in accordance with the MCA agreement.[11]

> Providing that the merchant's bankruptcy is an event of default was a key fact in a 2007 case, *Clever Ideas, Inc. v. 999 Restaurant Corp*.[12] In this case, the Supreme Court of New York, New York County found that two contracts labeled as "advanced sales" were loans. The court found the transactions were absolutely repayable because any default (including bankruptcy or the closing of the business) would trigger payment in full.

Similarly, the lack of recourse for the merchant's bankruptcy was cited as a positive factor in the respective state court decisions in *Merchant Cash & Capital, LLC v. Sogomonyan*,[13] and *Merchant Cash & Capital, LLC v. Frederick & Cole, LLC*,[14] and in the district court's decision *Colonial Funding*.[15]

However, the authors are aware of no state or federal New York decision where the outcome turned on whether the MCA agreement provided for recourse if the merchant filed for bankruptcy. Rather, in addition to *K9 Bytes*, there are two older decisions in which the subject MCA agreement was found not to be a loan despite the inclusion of recourse for the merchant's business failure.[16] Moreover, a limited review of decisions from the courts of other states indicates that including recourse for the merchant's bankruptcy is routinely considered a negative factor in evaluating whether the parties' relationship involves a bona fide purchase and sale relationship or a usurious loan, but is not considered decisive standing alone.

In considering the relevance of bankruptcy, it should also be kept in mind that all bankruptcy filings are not the same. Specifically, a merchant's decision to pursue debt relief under Chapter 11 could potentially benefit the MCA provider—assuming the bankruptcy court recognized the MCA agreement as a non-debt, purchase and sale relationship. Thus, treating a Chapter 11 filing as an event of default event may be both unnecessary and unwise.

In addition, there are other means for protecting against the economic consequences of the merchant's possible bankruptcy than designating the merchant's filing for bankruptcy an event of default in the MCA agreement. For example, the merchant's representations and warranties should expressly provide that no filing for bankruptcy relief (under any chapter) is either planned or contemplated. If the merchant then files for bankruptcy, the provider may have an action for breach of warranty. In addition, as in the Arch Funding agreement that was upheld in *K9 Bytes*, it may be possible to address the effects of bankruptcy in the personal guarantee rather than making the mere fact of filing a breach of the MCA agreement itself.

Lastly, because the law in this area continues to evolve and relevant court decisions are constantly emerging, the authors advise that the surest way to ensure that your MCA agreement remains enforceable is to have it reviewed on a periodic basis by experienced legal counsel.

Endnotes

1 Misc. 3d 807, 57 N.Y.S.3d 625, 2017 N.Y. Misc. LEXIS 1903, 2017 NY Slip Op 27166 (N.Y. Sup. Ct. May 4, 2017).

2 *Id.* at *11.

3 *Id.* at *13.

4 *Id.* at *14.

5 2017 N.Y. Misc. LEXIS 884 (N.Y. Sup. Ct. Mar. 10, 2017).

6 *Id*. at *9.

7 *K9 Bytes*, 2017 N.Y. Misc. LEXIS 1903 at *14.

8 *In re: R&J Pizza Corp*., No. 14-43066 (B.R., E.D.N.Y. Oct. 14, 2014).

9 These factors were: 1) language of the documents and conduct of the parties; 2) recourse to seller; 3) seller's retention of servicing and commingling of proceeds; 4) purchaser's failure to investigate the credit of the account debtor; 5) seller's right to

excess collections; 6) purchaser's right to alter pricing terms; 7) seller's retention of right to alter or compromise unilaterally the terms of the transferred assets; and 8) seller's retention of right to repurchase assets. *Id.* at *4-*5.

10 *Id.* at *7-*8.

11 *Id.*

12 *Clever Ideas, Inc. v. 999 Rest. Corp*., 2007 N.Y. Misc. LEXIS 9248 (N.Y. Sup. Ct. October 26, 2007).

13 2017 N.Y. Misc. LEXIS 1983 (N.Y. Sup. Ct. Jan. 9, 2017).

14 2016 N.Y. Misc. LEXIS 5084 (N.Y. Sup. Ct. Dec. 21, 2016).

15 Colonial Funding Network, Inc. v. Epazz, Inc., 2016 U.S. Dist. LEXIS 112414 (S.D.N.Y. Aug. 9, 2016).

16 *MERCHANTS ADVANCE, LLC, Plaintiff, -against- TERA K, LLC T/A TRIBECA FRANK CARABETTA, Defendants.*, 2008 N.Y. Misc. LEXIS 10889 (Sup. Ct. N.Y. Cty. Dec. 16, 2008); *Transmedia Rest. Co. v. 33 E. 61st St. Rest. Corp.*, 2000 N.Y. Misc. LEXIS 232 (N.Y. Sup. Ct. Feb. 7, 2000).