Merchant Cash Advance Litigation Is Getting Wilder

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By Jacob Nemon and Jeff Boxer. Published in the *New York Law Journal*.

According to lore, the merchant cash advance (MCA) industry was born in New York, and its law continues to be the law of choice in many MCA agreements. This has led to extensive litigation because, unlike dozens of other states, New York has a criminal usury cap of 25% for loans to corporations. In many litigations, MCA funders maintain that MCA agreements are not loans, and are therefore exempt; while business customers (referred to as "merchants") seeking to avoid their obligations, unsurprisingly, argue that they are in fact loans subject to the cap.

There are now dozens of trial-level, and several appellate-level, decisions on this issue. This well-developed MCA jurisprudence has resulted in more careful MCA agreement drafting in recent years, but some recent decisions suggest that MCA litigation is about to get wilder.

MCA Agreements Are Purchases of Future Receivables, Not Loans. When properly drafted, MCA agreements should not be subject to a usury cap because an MCA is not structured as a loan. In practice, however, usury caps have fueled extensive litigation against MCA funders, particularly in New York.

MCA transactions are akin to traditional factoring agreements. The funder purchases future receivables for a predetermined price, and repayment is contingent upon the business's success. Importantly, unlike a loan, the business does not have an absolute repayment obligation. A merchant does not have to remit receivables it does not receive as a result of a business failure, and the merchant's remaining non-receivables assets cannot be attached. There is also no interest rate in the MCA agreement that would cause the gross amount the business is required to remit to increase if its receivables are delivered over a longer period than originally estimated. These fixed remittances are estimates of an agreed percentage of the average daily receivables that can be adjusted at the merchant's request if receivables decrease. At the outset, the MCA funder takes the risk it may not be repaid if the business fails.

Nevertheless, merchants will often sue MCA funders seeking to void agreements that they maintain are simply "disguised" loans with absolute repayment obligations. Merchants typically claim that when the amounts of their fixed daily receivables remittances are annualized, they would effectively pay the funder a rate of far more than 25% per year. Most suits have been dismissed at the trial court level because the written agreements evidence that the MCAs were not loans. Furthermore, many courts have found that despite various protections for the funders—like security agreements, personal guaranties of performance and confessions of judgment—funders still bare the substantial risk of never recovering their investments if the business failed.

This has particularly been true of MCA agreements that contain a "reconciliation" provision which allow the business to request, and require the funder to provide, a true-up of the business's daily remittances to reflect diminished average receivables. Such agreements, which reflect the actual ebbs and flows of the business and adjust remittances accordingly, are usually found not to be loans.

MCA Appellate Decisions. New York—the most important state for MCA law—did not have guidance from any appellate courts until recently.

In 2018, the First Department issued a terse decision appearing to greenlight MCA arrangements in New York. See *Champion Auto Sales v. Pearl Beta Funding*, 159 A.D.3d 507, 507 (1st Dep't 2018) (finding that "[t]he evidence demonstrates that the underlying agreement leading to the judgment by confession was not a usurious transaction."). However, the decision provided no detailed framework for ascertaining which provisions in an MCA agreement could convert it from a lawful purchase agreement to a usurious loan.

Some of that detail was provided by the Second Department in *LG Funding v. United Senior Props. of Olathe*, 181 A.D.3d 664, 666 (2d Dep't 2020), which adopted a three-part test used by some lower courts to determine whether an MCA agreement was a loan: "(1) whether there is a reconciliation provision in the agreement; (2) whether the agreement has a finite term; and (3) whether there is any recourse should the merchant declare bankruptcy." The nature of the reconciliation provision was particularly important to the Second Department, which focused on the use of the term "may" in the reconciliation provision, which could give the funder discretion whether to adjust remittances to reflect diminished receivables.

This spawned a substantial amount of litigations about whether reconciliation is the business's right (and therefore the agreement is not a loan) or discretionary and illusive (therefore creating an absolute payment obligation akin to a loan). Where courts prior to *LG Funding* largely sided with funders, subsequent decisions have scrutinized the reconciliation obligation closely. Where the *LG Funding* factors indicate an agreement may be a loan, courts have granted preliminary injunctions in favor of merchants or denied motions to dismiss by funders.

Last month, the First Department in *Davis v. Richmond Capital Group*, 2021 N.Y. Slip Op. 03111, ¶ 1 (1st Dep't May 13, 2021), upheld the denial of a motion to dismiss, find that the MCA agreements in question may be loans due to:

the discretionary nature of the reconciliation provisions, the allegations that defendants refused to permit reconciliation, the selection of daily payment rates that did not appear to represent a good faith estimate of receivables, provisions making rejection of an automated debit on two or three occasions without prior notice an event of default entitling defendants to immediate repayment of the full uncollected purchased amount, and provisions authorizing defendants to collect on the personal guaranty in the event of plaintiff business's inability to pay or bankruptcy.

This likely means that, post *Davis* trial court decision will focus on additional provisions in MCA agreements beyond the *LG Funding* factors to ascertain the true nature of the transaction. Furthermore, the decision suggests that, even if the MCA agreement was valid when made, a subsequent failure by the funder to provide reconciliation would not only constitute a breach but could evidence that a funder treated its agreement as a loan rather than an MCA.

Impact of 'Davis' Is Felt. The past few years have seen a raft of litigations against MCA funders by state and federal investigators alleging usury and violations of other consumer protection statutes.

In *People of the State of New York v. Richmond Capital Group*, N.Y. Co. Index No. 451368/2020, the New York Attorney General alleges that certain funders, and their principals, violated the criminal usury law because of their *pre-contractual* conduct: The transactions are described as "loans" in sales calls, emails, advertising materials and webpages, which also discuss payment periods, and because they are underwritten as loans—reviewing credit ratings and bank balances rather than historical receivables. The NYAG also alleges that *post-contractual* conduct renders the agreements loans, including filing confessions of judgment or enforcing personal guaranties upon single missed payments, filing false affidavits, double-dipping on daily remittances and refusing to grant reconciliations.

On June 2, 2021, Supreme Court Justice Andrew Borrok heard oral argument on and denied the MCA respondents' motions to dismiss the NYAG petition. He rejected what he described as their "form over substance" argument—namely that because the MCA agreements are not structured as loans, they cannot be usurious. Instead, citing the First Department's recent *Davis* decision, he indicated that the NYAG had sufficiently alleged fraudulent conduct by the funders that overcame any dismissal on documentary evidence arguments by the funders.

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The court seems to be interpreting *Davis* as permitting it to look not only past the four corners of an MCA agreement to determine whether there was usurious intent at the time of the transaction, but to subsequent misconduct that could retroactively render the MCA agreements loans subject to New York's criminal usury law.

Conclusion

The recent *Davis* decision will likely spur usury litigation against MCA companies. Funders using legacy agreements drafted when the MCA industry was in its infancy are targets for such litigation, but even regularly updated agreements ought to be reviewed again in this environment.

However, litigation—and frankly criminal—exposure cannot be mitigated solely by having a well-drafted form. The litigations and investigations to come may examine not just the four corners of the MCA agreements, but also pre- and post-contractual conduct by funders, salespersons, underwriters and independent sales offices, to determine whether the product was accurately presented and the players acted in conformity with the terms of the agreements.

Additionally, various state legislatures (including New York) have introduced or passed legislation covering MCA agreements. These require certain pre-contractual disclosures of terms of the agreements, including, most confoundingly, an annual percentage rate (APR) and repayment term. However, MCAs have neither, and would be accused of violating two of three *LG Funding* factors if they did.

The time to update MCA agreements, come into full compliance with New York law, and train personnel in the basics of MCA law, was yesterday, but the impetus to do so has not expired. MCA funders should reach out to experienced MCA counsel to review their forms and advise them on best practices.

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