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# SDNY Is The New Worst Place To Litigate MCA Disputes

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By Jacob H. Nemon. Published in the *New York Law Journal*.

Once upon a time, I lamented that The Worst Place To Litigate Merchant Cash Advance Disputes Is Out-of-State. Since last June, beginning with the issuance of the befuddling decision in *Fleetwood Services v. Ram Capital Funding LLC*, 2022 U.S. Dist. LEXIS 100837 (S.D.N.Y. June 6, 2022), the Southern District of New York has taken over the "worst place to litigate" title for these merchant cash advance (MCA) transactions. Indeed, some SDNY judges are developing a federal MCA legal doctrine that may be read to substantially deviate from New York state authorities.

## New York Law

In MCA transactions, the funder purchases a percentage of future receivables from a merchant for a discount and receives regular remittances—usually a fixed daily or weekly amount as an estimate of the specified percentage of the merchant's average receivables—until the full purchased amount is delivered from the merchant's actual receivables.

New York State courts, including *Principis Cap., LLC v. I Do, Inc.*, 201 A.D.3d 752 (2d Dept. 2022), established a useful tripartite test for determining whether MCA contracts met the criteria for being true purchases contingent upon the merchant's generation of receivables (that are not covered by New York's criminal usury cap of 25% per annum) rather than loans.

(1) Does it contain a reconciliation provision to adjust regular remittance amounts?

(2) Does it effectively have an unlimited term if the merchant requires more time to deliver receivables due to business slowdowns or is the term finite?

(3) Does the funder have recourse against the merchant in bankruptcy?

## 'Fleetwood's' New Approach

In *Fleetwood*, Judge Lewis Liman decided that these three factors—the touchstone of New York law since at least 2017—"provide only a guide to analysis," but neither dictate the conclusion nor need to all be present for an MCA transaction to be judicially recharacterized as a loan.

*Fleetwood* shredded apart the contract at issue and determined that in light of some of its other (usually overlooked) provisions (not to mention a factual record of egregious misconduct by that particular funder treating the transaction as a loan with absolute payment obligations), there was no transfer of the risk of loss to the funder in the event the merchant's business failed.

*Fleetwood* found (i) an overbroad description of the receivables being purchased, (ii) no provision giving the MCA funder direct control over the account into which receivables are deposited, and (iii) an all-assets security provision rather than a collateral package that includes only the right

to receivables to secure performance, when read holistically with the rest of the contract, supported the finding that the transaction was a loan, not a sale of assets.

*Fleetwood* granted summary judgment on the merchant's civil Racketeer Influenced Corrupt Organizations Act (RICO) claim—with attendant awards of damages, treble damages and attorney fees—since the MCA funder had collected what the court determined was an "unlawful debt."

### Federal MCA Doctrine

Since *Fleetwood*, some SDNY jurists followed suit, issuing a number of merchant-friendly decisions that not only form a new federal MCA doctrine that may be read to deviate from New York state decisions (which may ultimately be sorted on certification to the New York Court of Appeals), but which decisions have spurred a slew of civil RICO filings by merchants looking to void still unsettled MCA transactions and to recover damages for closed-out transactions going back up to four years (the RICO statute of limitations). These decisions mostly tracked *Fleetwood*'s reasoning in denying the funders' motions to dismiss.

Some notable developments in the federal MCA doctrine are addressed below.

### Lateral Recovery

In *Lateral Recovery LLC v. Capital Merchant Services, LLC*, 2022 U.S. Dist. LEXIS 181044 (S.D.N.Y. Sep. 30, 2022), Judge Liman walked back some harsher aspects of his *Fleetwood* ruling, albeit not expressly. Reading his earlier decision, one might think few legacy MCA contract forms could pass muster because many contained the very provisions he found could render an MCA agreement a loan.

However, *Lateral Recovery* analyzed three different MCA forms and drew three different conclusions: one was a usurious loan on its face, one raised a question of fact whether it is a loan, and one on its face was a true receivables purchase agreement because it contained a reconciliation provision allowing the merchant to recover any amounts overpaid since entering the deal and to adjust regular remittances. A review of the actual document that was found *not to be a loan* reveals that it contained an all-assets security pledge and no provision granting the funder control of the account in which receivables are deposited.

### 'Precisionworks'

In *Precisionworks MFG, LLC v. Union Funding Source, Inc.*, 2022 U.S. Dist. LEXIS 194410 (S.D.N.Y. Oct. 25, 2022), Judge Lorna Schofield compelled a merchant to arbitrate its civil RICO claims notwithstanding the merchant's argument that being so compelled would be "unconscionable" due to the agreement containing the arbitration provision being an allegedly usurious loan. Judge Schofield determined that, where an MCA agreement contains an arbitration provision, it is up to the arbitrator, not a court, to determine in the first instance whether the agreement is void.

*Precisionworks* was monumental because it confirmed MCA funders had the continued protection of an arbitral forum, which was an open question following Judge Jed Rakoff's decision just a few weeks earlier in *Haymount Urgent Care PC v. GoFund Advance, LLC*, 2022 U.S. Dist. LEXIS 186768 (S.D.N.Y. Oct. 12, 2022).

### 'Haymount'

*Haymount* seemed to indicate that *any* provision in an MCA contract could be voided under New York's usury laws. *Haymount* denied a motion by the defendants to strike a class action demand in the complaint because of a class action waiver in the MCA agreement. Judge Rakoff stated the waiver was likely void since a usurious instrument would be void *ab initio*, including its class action-waiver.

This decision initially appeared catastrophic for MCA funders because it raised the specter that they not only would have to defend civil RICO claims by single merchants concerning single deals, but could potentially be forced to defend class action claims brought in the SDNY under its more severe usury analysis. To make matters worse, the class claims could potentially be brought on behalf of all merchants nationwide with whom the funder did business during the four years preceding the lawsuit filing and be exposed to those merchants' claims for actual and treble damages and attorneys' fees.

More recently, however, Judge Rakoff dashed the merchants' hopes by denying a motion for certification of such a nationwide class. *Haymount Urgent Care PC v. GoFund Advance, LLC*, 2023 U.S. Dist. LEXIS 6914 (S.D.N.Y. Jan. 13, 2023). Since the MCA agreement's New York choice-of-law provisions may, like the class action waiver provision, be void if New York law applied, there simply could be no "commonality" of the putative nationwide class's claims. A court determining class-wide civil RICO claims would need to engage in 50 different choice-of-law analyses and would be confronted with a wide array of usury thresholds, as well as a great number of states without usury laws.

Buried in the later *Haymount* decision is also a critical footnote 5 that provides a bright light to MCA funders. Judge Rakoff noted the funders' "strong arguments that the agreements themselves, in light of their provisions for both prospective and retrospective reconciliation of the initially estimated remittance amounts to a business's actual revenues as they come in, do not on their face constitute unlawful loans, rather than bona fide purchases of future revenues."

Like Judge Liman in *Lateral Recovery*, it appears Judge Rakoff acknowledges that a well-drafted MCA clause with an appropriate mandatory reconciliation provision will not on its face be a usurious loan—at least so long as the funders do proper underwriting, use the forms correctly and do not engage in misconduct.

### Fix Your Contracts

While the SDNY's MCA doctrine and the slew of new filings suggest the civil RICO winter has come for MCA funders with New York choice-of-law provisions, *Fleetwood* and its progeny provide useful guidance for fixing MCA agreements for a sunnier future. The stricter expectations of the SDNY jurists who will preside over future cases make it critical to examine whether the forms funders are using will survive when—not if—they are sued.

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