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LEGAL lines

Why Are MCAs Doing So Well in the Courts?

BY JEFFREY A. WURST

Merchant Cash Advances (MCAs) are a divisive issue in the lending community, with good reason. Jeffrey Wurst examines the pitfalls that can undermine an ABL lender and observes that many judges make rulings regarding MCAs without fully understanding the nuances of the issues.

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Okay, this title has already alienated a chunk of our reading audience, so let me clarify.

Let's first separate Merchant Cash Advance (MCAs) into two groups:

First are MCAs that advance money and get repaid solely from the collection of future receivables (assuming the risk of collection) and those that advance money and get repaid by taking daily or weekly ACH payments from the *client's* bank account whether or not any receivables actually exist.

Second are MCAs that rely on the performance of receivables found in factoring, which are generally based on true sales of the future receivables and without recourse. Although certain MCAs claim to be without recourse because the *client* is not creditworthy and any claim against the merchant is uncollectable, that does not qualify as a true sale.

Let's focus on the first type of MCA — the recurring ACH repayment method which is not connected to the performance of future receivables. In other words, ACH payments made even when no receivables are created or that do not change based on a percentage of receivables collected.

Whether an MCA is a usurious loan first depends on whether the merchant sold the receivable or borrowed money with the receivable as collateral. Whether the sale of the receivable was a *true sale* under applicable law determines this.

Let's look at these transactions under New York law, which has the harshest usury penalties in the country. Under New York law, the penalty for lenders making a usurious loan is not being deprived of any interest payments, as it is in many jurisdictions, but being deprived of receiving both interest *and principal*. In other words, the borrower gets a windfall by forgiveness of debt when it has borrowed money under usurious terms. Thus, it should not come as a surprise that when confronted with a lawsuit to recover on advances made to a merchant, that merchant attempts to claim the high cost of funds they are paying is usurious.

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The True Sale Test

So, what is a true sale? This is important because, for a purchase of receivables to avoid being deemed a loan (and often a usurious one at that), the purchase needs to first pass a *true sale* test.

To avoid a claim that the advance was made on usurious terms, a sale of receivables must be a *true sale* (and not a loan). While few courts have engaged in detailed *true sale* analysis, some have abbreviated the standard into three prongs:

1. Whether or not the maker of the MCA is absolutely entitled to repayment under all circumstances. For a true loan, it is essential to provide for repayment absolutely and at all events or to secure the principals in some way as distinguished from being put in a hazard.[1]
2. The MCA agreement must have an indefinite term, evidencing the contingent nature of the repayment plan.
3. Whether the purchaser of receivables has any recourse should the merchant declare bankruptcy.

1 *NY Capital Asset Corp. v. F & B Fuel Oil Co.*

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While these indicia provide a reasonable method to determine whether the transaction is a true sale or a disguised loan, courts, while stating this standard, rarely engage in an analysis applying the facts to the standard. As a result, it appears some courts miss the point.

One of the recurring facts many courts have failed to consider is when a "purchaser of receivables" makes MCAs and requires a confession of judgment from the merchant, that the confession of judgment may indicate that the "purchaser" has recourse other than to the purchased receivables.

Of course, there is no assurance the judge hearing the case will be familiar with the UCC or similar law. Instead, many judges blindly rely on the conclusions of parallel judges, even when the facts may not be sufficiently similar. Two cases, coincidentally, rely on the conclusions of other courts, using identical conclusory language:

> Many trial courts have examined similar agreements in the last several years, and have largely determined that most are not loans, but purchases of receivables.[2]

One judge ruled:

> New York Courts have held that a contract such as the within agreement are not loans and are not subject to usury laws. In *Merchants Advance*, the court found an agreement for the purchase of future receivables and sales proceeds lacked "the necessary elements of a loan transaction" and was not subject to usury laws.[3]

Judges Miss the Point

The problem is, in many cases the judge never considers the reason why New York courts consider certain agreements not to be loans — perhaps because they are *true sales* — even when the facts of the case at bar is not a true sale. This judge clearly missed the point — probably because the defendant's attorney never adequately explained the issue.

Keep in mind that these cases typically involve small amounts, and the attorneys representing the merchants are inexperienced in commercial finance and UCC matters.

Some courts have considered whether the merchant actually has collections of receivables and whether repayment of the advance is contingent upon the merchant actually generating sales and those sales actually resulting in the collection of revenue.

Sales Disguised as Loans

That said, some courts have peeled back the onion and have seen that certain MCAs are, in fact, disguised loans:

> The court comes to the inevitable conclusion that the real purpose of the agreement was for plaintiff to lend money to defendants at the usurious interest rate set forth therein, and that defendant agreed to borrow the money based on the same usurious terms dictated by plaintiff. Denominating a loan document by another name, as in this case, by calling it a "Merchant Agreement," does not shield it from the judicial determination that it contemplates a criminally usurious transaction. Accordingly, as the party seeking to exact criminally usurious interest, plaintiff is also "not entitled to equitable relief."[4]

MCAs have established themselves as viable methods of financing for small businesses, many of which are not otherwise deemed to be loan worthy, and ABLs must monitor them and take appropriate measures to protect the integrity of their loans.

Another court concluded:

> In the instant case, however, the submitted affidavits and exhibits clearly and unequivocally demonstrate that the agreement is criminally usurious on its face, obviating the need for a superfluous plenary action.[5]

So, what is the take away?

Are MCAs Bona Fide?

ABLs remain skeptical whether MCAs are *bona fide*. They remain concerned that merchants often *stack* (making a series of MCAs one on top of another) MCAs with ACH payments automatically being deducted from the merchant's accounts and leaving the ABL's borrower strapped for cash. They remain concerned that MCAs are made without regard to the ABL's security interests. The problem is, ABLs have no practical way to monitor what ACH commitments its borrowers have made unless the ABLs have access to their borrowers' bank account statements or require account debtors to make payments to a lockbox.

The fact is, where MCAs are effected as true sales, courts will uphold them, and where they are disguised as loans, some will avoid scrutiny and be able to have recourse. Some will be caught as disguised loans and surrender any recovery.

Monitoring ABL borrowers, especially those that may be vulnerable with cash needs, must become a regular practice such as monitoring for tax liens and additional UCC filings.

Of course, that adds to the cost of making and monitoring a loan, something ABLs may be reluctant to do in a competitive marketplace where additional monitoring means less profitability.

What remains, however, is that MCAs have established themselves as viable methods of financing for small businesses, many of which are not otherwise deemed to be loan worthy, and ABLs must monitor them and take appropriate measures to protect the integrity of their loans. abfj

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2 This precise quote appears in each of *LG Funding, LLC v. Branson Getaways* and *K9 Bytes v. Arch Capital Funding*.
3 *IBIS Capital Group v. Four Paws Orlando*. 2017 N.Y. Misc.
4 *Pearl Capital Rivis Ventures v. RDN Construction*. 54 Misc.3d 470. 2016.
5 *Merchant Funding Services v. Volunteer Pharmacy*.