
Southeast Bankruptcy Workshop

# The Wild West of Unconventional Lending: "I Need Money!" A Look at Factors, Merchant Cash-Advance Lenders and Litigation-Funders

**J. Ryan Yant, Moderator**
Carlton Fields, P.A. | Tampa, Fla.

**Craig M. Geno**
Law Offices of Craig M. Geno, PLLC | Ridgeland, Miss.

**Hon. Jennifer H. Henderson**
U.S. Bankruptcy Court (N.D. Ala.) | Tuscaloosa

**Edward J. Peterson, III**
Johnson Pope Bokor Ruppel & Burns, LLP | Tampa, Fla.

**John A. Thomson, Jr.**
Adams and Reese LLP | Atlanta

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# The Wild West of MCA Lending

**Tim Anzenberger**
**Allyson Donohue**
**Craig M. Geno**
**Jennifer Hudson**
**Jacob Johnson**
**Edward Peterson**
**John Thomson**
**Ryan Yant**

## History of MCA Lending

What is a merchant cash advance? The business sells or pledges its future receivables to a "purchaser" or the "lender" in exchange for an immediate advance of cash. Large interest rates are often associated with the transactions. Basically, this is the equivalent of a payday advance loan for business.

What happens after the loan or sale occurs?

Purchaser/lender performs regular reconciliations and withdraws an agreed sum from the merchant's account as the receivables are collected, typically on a daily basis.

Why would any business agree to this?

Merchant cash advances gained popularity following the Great Recession but have existed for more than twenty years. They are often marketed to small businesses that need working capital but are more susceptible to disruptions in cash flows and may be unable to qualify for a loan.

## Overview of Bankruptcy Issues

How you characterize a merchant cash advance transaction – either as a loan or a sale of receivables – impacts many aspects of a bankruptcy case. Most obviously, whether a transaction is a secured financing transaction, or a sale of receivables impacts on the determination of what is property of the bankruptcy estate.

It can also shape the application and the effect of the automatic stay or positions parties take (or do not take) with respect to the use of cash collateral. The characterization of the transaction also influences the analysis of potential preferential transfer actions under section 547 of the Bankruptcy Code. It is also relevant in the claims objection process, as the interest charged would often be usurious.

How do courts determine whether a transaction is a loan or sale of receivables?

In evaluating whether a transaction is a loan or a sale of receivables, courts generally engage in a flexible three-factor analysis.

Courts consider "(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." Other factors include whether the filing of a UCC-1 is required to take a security interest in the receivables and whether a personal guaranty to secure the debt is required.

Shoot the Moon Factors

(1) whether the buyer has a right of recourse against the seller;

(2) whether the seller continues to service the accounts and commingles receipts with its operating funds;

(3) whether there was an independent investigation by the buyer of the account debtor;

(4) whether the seller has a right to excess collections;

(5) whether the seller retains an option to repurchase accounts;

(6) whether the buyer can unilaterally alter the pricing terms;

(7) whether the seller has the absolute power to alter or compromise the terms of the underlying asset; and

(8) the language of the agreement and the conduct of the parties.

The ability for a merchant's payments to be adjusted based on a reconciliation is a hallmark of a true sale of the receivables.

If the amount of the monthly payment changes, the term of the agreement is not finite and will vary based on the fluctuations in the amount of the monthly payments.

Likewise, contract provisions where insolvency or the filing of bankruptcy constitute a default resulting in the acceleration of the balance due or requiring a confession of judgment tend to indicate that the obligation to repay is absolute and suggest that the transaction should be characterized as a loan, rather than a true sale of receivables.

Distilled to its essence, the primary feature distinguishing a loan from a cash advance is that a lender "is absolutely entitled to repayment under all circumstances" regardless of whether the merchant earns future income.

**Case Review –**

*Ideas v. 999 Restaurant Corp.*, No. 0602303/2006, 2007 WL 3234747 (N.Y. Sup. Ct. Oct. 12, 2007).

One of the first published decisions about a merchant cash advance concept involving a restaurant that entered an advance meal sales agreement, pursuant to which it was advanced $22,000 in exchange for a portion of its future credit card receipts. The advances ballooned to over six figures, and a balance of approximately $135,000 remained at the time the lawsuit was filed. The MCA sued the restaurant to enforce the agreement and argued that the Illinois law, a state with no usury statutes, applied based on the choice of law provision. The Court rejected that position and declined to give effect to the choice of law provision in the agreement, opting to apply New York law. The court characterized the transaction as a loan and allowed the restaurant to assert the usuary defense.

*In re R&J Pizza Corp.*, Case No. 14-43066, 204 WL 12973408 (Bankr. E.D.NY. 2014).

The Court found that the purchase agreements represented a true sale of receivables and do not constitute property of the debtor or its estate and prohibited debtor from using 13% of future credit card receivables until the MCA party was paid in full. The Court focused on the fact that the purchase agreement consistently used "purchase" and "sale" and "buyer" and "seller" as defined terms and that the UCC-1 described the transaction as a purchase and sale. The purchase agreement did not provide for any recourse against the debtor for non-collection—in other words, if the debtor closed up shop, the purchaser was out of luck. The purchase agreement also included only a limited personal guaranty of the debtor's principal.

*CapCall, LLC v. Foster (In re Shoot the Moon, LLC)*, 635 B.R. 797 (Bankr. D. Montana 2021).

Shoot the Moon was a business enterprise that consisted of nineteen LLCs that owned and operated sixteen restaurants throughout Montana, Idaho, and Washington. Note that the nineteen Shoot the Moon entities ultimately merged into one LLC—Shoot the Moot, LLC—the debtor in the case. In response to financial pressures, some of which dated back to the 2007-2009 Great Recession, while others were related to improvements to the restaurants, Shoot the Moon sought and obtained financing from investors, family, friends, traditional bank lenders and trade creditors. When that financing was exhausted, Shoot the Moon then engaged in 18 merchant cash advance transactions. CapCall provided Shoot the Moon with immediate cash, but the amounts promised to CapCall from future revenues substantially exceeded the amount of the advance.

CapCall received payments from the bank account of a defunct entity, Shoot the Moon Grizzly, LLC. A chapter 11 trustee was appointed and sold substantially all of the estate's assets. CapCall did not object to the sale or the payment of senior secured creditors. The trustee sought and obtained turnover of about $230,000 from the credit card processor and stipulated with CapCall to segregate the funds pending resolution of the disputes. CapCall filed a proof of claim for conversion of receivables. The trustee initiated an adversary proceeding seeking title to the segregated funds, avoidance and recovery of preferential transfers, and remedies stemming from usurious interest rates. The court concluded the transactions were secured loans and violated applicable usury laws.

Key take aways—the mere fact that the transactional document designates the transaction as a sale does not make it so. The transactional documents also granted broad security interests and included broad personal guaranties of payment and performance, which is more characteristic of a loan. Also—the absence of a repurchase provision did not automatically make the transaction a sale.

*In re Brooks*, 619 B.R. 669 (Bankr. C.D. Ill. 2020).

*GMI Group, Inc. v. Unique Funding Solutions, LLC (In re GMI Group, Inc.)*, 606 B.R. 467 (N.D. Ga. 2019).

The bankruptcy court found that Unique's loan was criminally usurious under New York law and directed the debtor to submit additional briefing regarding the appropriate remedy for a criminally usurious loan. As reflected in the debtor's supplemental briefing, two major remedies exist—declaring the loan void or revising the agreement to provide for a non-usurious interest rate. Sidebar—while not the focus of the briefing in this case, there is a question as to whether either of these remedies result in funds being returned to the debtor through theories of civil damages that may be available under usuary statutes or whether the voiding of the obligation opens the door for chapter 5 claims and causes of action. In any event, not surprisingly, the case settled and was dismissed shortly after the supplemental brief was filed by the debtor.

This adversary is one of a trio of adversary proceedings filed by the debtor against MCA lenders (Reliable Fast Cash and Expansion Capital Group). The other adversary proceedings involved similar claims, but the outcomes were different, as a result of the choice of law provisions and the terms of the agreements between the parties. In the Expansion Capital case, the court dismissed criminal usury claims, as criminal usury is not available under South Dakota law. (Sidebar—Texas is also a favorite for MCA lenders, as Texas statutes provide for an irrebuttable presumption that a sale is a sale if the agreement so states.) Short story—choice of law matters, a lot. Choice of law not only controls whether a usury claim exists but may also inform as to whether usury is raised as affirmative relief or merely a defense and may also impact on available remedies.

*Craton Entertainment, LLC v. Merchant Capital Group*, LLC, 314 So. 3d 627 (Fla. 3d DCA 2021).

The Third DCA upheld the trial court's ruling on summary judgment determining that an MCA purchase and sale agreement was not a loan and, therefore, was not subject to Florida's criminal usury act. In declining to recharacterize the transaction, the trial court focused on the fact that the agreement did not provide an absolute right by the party advancing the funds to demand repayment from the debtor. The principal's guaranty also did not guaranty repayment, but performance under the purchase and sale agreement—that seems to be a distinction without a difference to me and splitting of hairs. While creditor's rights lawyers will surely tout this as a win for the MCA clients, it is worth noting that the Third DCA did not author a full opinion—simply Affirmed, and then a string of case cites.

# Faculty

**Craig M. Geno** is a member of the Law Offices of Craig M. Geno, PLLC in Ridgeland, Miss., and his bankruptcy practice consists representing secured and unsecured creditors, unsecured creditors' committees, chapter 11 debtors-in-possession and bankruptcy trustees in chapter 7 and 11 cases. Additionally, he has served as a trustee in chapter 11 cases and is a subchapter V trustee in the Northern and Southern Districts of Mississippi and the Western District of Tennessee. His practice areas also include commercial and corporate litigation. Mr. Geno is a frequent writer and lecturer on various bankruptcy topics. He is a member of the American Bar Association, Mississippi State Bar Association (for which he served as president of its Law Office Economics Section from 1993-94), Mississippi Bar Foundation, Federal Bar Association (for which he served as the Southern District Vice President of the Mississippi chapter from 1989-90), and the Mississippi Bankruptcy Conference (for which he served as president in 2001). In addition, he is a member of ABI, the Business Bankruptcy Subcommittee of the Section of Business Law of the American Bar Association, and the Turnaround Management Association. Mr. Geno is a Fellow in the American College of Bankruptcy, the Mississippi Bar Foundation and the American Bar Foundation. He is listed in *The Best Attorneys of America* and as a "Top Fifty Attorney" in *Super Lawyers*, and his firm is listed in *U.S. News & Best Lawyers* "Best Law Firms." Mr. Geno is Board Certified in Business Bankruptcy Law by the American Board of Certification, served on its board of directors for eight years, and served as its president and chairman. He also served on the Mississippi State Bar as special counsel for the Committee on Character and Fitness from 1984-87, and as a member of the Committee on Character and Fitness from 1987-2013. Mr. Geno received his undergraduate degree in 1975 and his J.D. in 1978 from the University of Mississippi, during which time he served on the law school's Moot Court Board.

**Hon. Jennifer H. Henderson** is Chief U.S. Bankruptcy Judge for the Northern District of Alabama in Tuscaloosa, initially sworn in on Feb. 16, 2015,and named Chief Judge on Oct. 1, 2022. Previously, she was a partner with Bradley Arant Boult Cummings LLP's Bankruptcy, Restructuring and Distressed Investing Practice Group in Birmingham, Ala., where she represented debtors and creditors in bankruptcy cases, out-of-court workouts and restructurings and bankruptcy- related litigation. Judge Henderson clerked for Hon. Thomas B. Bennet and is listed as a 2014 Alabama Super Lawyers "Rising Star." She received her B.A. *magna cum laude* from Birmingham-Southern College in 2001 and her J.D. *summa cum laude* form the University of Alabama School of Law in 2004, where she was a member of the Order of the Coif and a special works editor for the *Alabama Law Review*.

**Edward J. Peterson, III** is a partner with Johnson Pope Bokor Ruppell & Burns, LLP in Tampa, Fla., where he specializes in the representation of debtors and creditors in out-of-court workouts and bankruptcy cases and proceedings throughout the Southeast. He also has experience representing creditor committees and specializes in commercial litigation in all courts, including litigation involving directors and officers. Mr. Peterson is actively engaged in various representations in Alabama and Florida. In addition, he has represented both assignors and assignees in assignments for the benefit of creditors. Mr. Peterson appears regularly in state courts in connection with civil litigation arising out of loans secured by real estate in the Florida panhandle and elsewhere. He was president of the Turnaround Management Association of Florida and a past president of the Tampa Bay Bankruptcy Bar Association, has published articles on bankruptcy issues, and has spoken on multiple occasions

on insolvency issues in Florida and Alabama. Over the past three years, Mr. Peterson has filed numerous subchapter V cases. He received his B.A. in economics in 1995 from Kenyon College and his J.D. *magna cum laude* in 1999 from the University of Alabama, where he was admitted to the Order of the Coif.

**John A. Thomson, Jr.** is special counsel with Adams and Reese LLP in Atlanta. He has advised clients on commercial litigation and bankruptcy matters for more than 30 years. Mr. Thomson represents clients in matters related to commercial finance and debtor/creditor issues. He has served in a broad range of roles in the bankruptcy courts, including counsel to secured financial institutions, indenture trustees, commercial trade creditors, life insurance companies, private-equity investors, and purchasers of distressed debt in all facets of commercial bankruptcies. Mr. Thomson has served as counsel to a number of unsecured creditors' committees, and served as a chapter 11 trustee for a health care operating company. His litigation work has included litigating matters in actions arising out of breach of contract, shareholder disputes, valuation of real and personal property collateral, the appointment of receivers, declaratory judgment actions related to bond issues, leases of commercial property, real estate development ventures, repossession of commercial collateral and execution of judgments. In addition to his litigation and transactional skills, Mr. Thomson is a graduate of the ABI's Mediation Training at St. John's University, and he is qualified as a mediator in disputes arising out of bankruptcy and creditors' rights matters. He is a Fellow of the American College of Bankruptcy, a past president and chairman of the board of the Southeast Bankruptcy Law Institute, and the former chair of the Atlanta Bar Association's Bankruptcy Section from 2013-14. He also is a Master of the W. Homer Drake Inn of Court and a member of the Bankruptcy and Litigation Sections of the Georgia Bar Association, as well as a member of the ABI's Finacne and Banking, real Estate and Asset Sales Committees. Mr. Thomson is listed in *Chambers USA* for Bankruptcy/Restructuring: Georgia (2019-22), *The Best Lawyers in America* for Banking and Finance Law, Bankruptcy and Creditor/Debtor Rights/Insolvency & Reorganization Law and *Georgia Super Lawyers* for Bankruptcy: Business, Business Litigation (2010-23). He received his A.B. in economics in 1981 from Davidson College and his J.D. in 1986 from the University of Georgia School of Law.

**J. Ryan Yant** is a shareholder with Carlton Fields, P.A. in Tampa, Fla., where he focuses on bankruptcy and creditors' rights law. In bankruptcy, he predominantly represents creditors in all case aspects. Mr. Yant has a robust practice representing merchant cash advance providers inside and outside of bankruptcy court, with a special focus of pursing nondischargeability actions relating to merchant cash advance agreements, having tried cases in both Florida and Georgia. Prior to joining Carlton Fields, he clerked for Hons. K. Rodney May and Roberta A. Colton in the U.S. Bankruptcy Court for the Middle District of Florida after beginning his practice as a debtor's attorney with a focus on personal and corporate chapter 11 debtor representation. Mr. Yant has been listed in *The Best Lawyers in America* as one of its Ones to Watch for Bankruptcy and Creditor/Debtor Rights/Insolvency and Reorganization Law since 2021. He received his B.S. *cum laude* in 1986 from the University of Florida, his M.B.A. with honors in 2013 from Stetson University and his J.D. *cum laude* in 2013 from Stetson University College of Law.