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abiLIVE webinar series

Intersection of MCAs and Bankruptcy

August 1, 2024

12:00-1:15 P.M. ET

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Meet the Panel

- Michael Lessne – Moderator
- Scott Bogucki
- Matt Hale
- Ryan Yant
- Craig Geno

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Overview and History of MCAs

- What is an MCA?
- History of development of the MCA as an alternative funding tool
- Prevalence of MCAs

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What makes an MCA an MCA?

- Distinction from loans
  - Indefinite repayment term
  - Reconciliation provision
  - No true interest component
    - What is the “specific percentage”?

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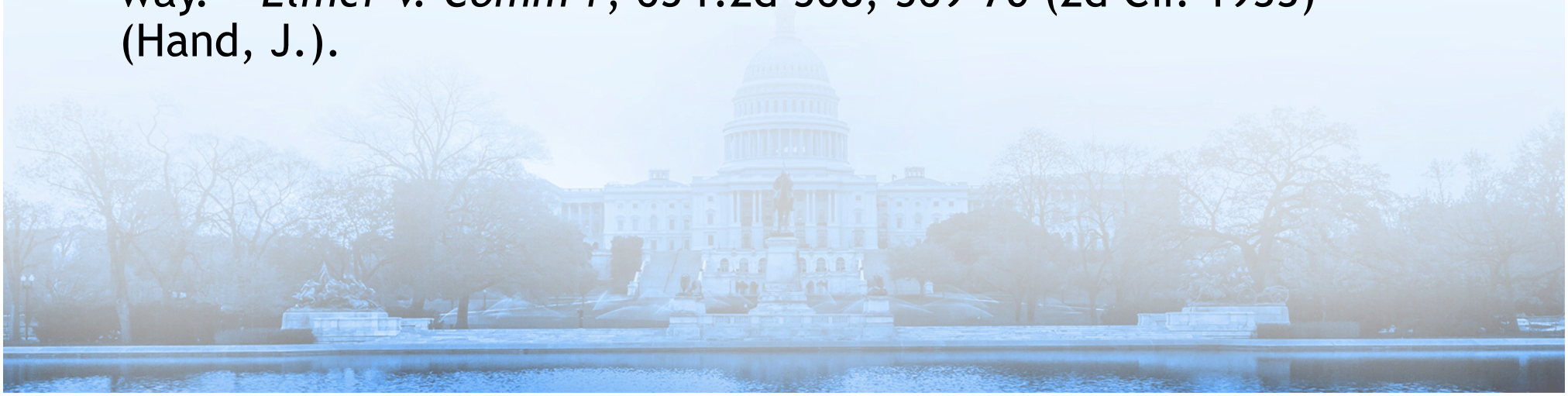
True Sale or Disguised Loan?

"Such transactions are somewhat ambiguous and admit of definition as loans or sales on slight differences.... It is possible, as we have suggested, to construe these transactions in either way." *Elmer v. Comm'r*, 65 F.2d 568, 569-70 (2d Cir. 1933) (Hand, J.).



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MCA transaction recharacterized as a loan.

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

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.

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MCA transaction was found to be a true sale of future accounts receivables.

In re R&J Pizza Corp., 2014 Bankr. LEXIS 5461 (Bankr. E.D.N.Y. Oct. 14, 2014)

Factors:

- (1) all of the underlying documents consistently referred to the transaction as a "purchase" and "sale" and to the parties as "Buyer" and "Seller," and did not include any provision allowing for interest to be paid;
- (2) the agreement did not provide for recourse against the business for non-collection and the personal guarantee was effective only under a limited set of circumstances;
- (3) the debtor had no right to process or repurchase the accounts, and no ability to commingle proceeds; and
- (4) MCC had no right to alter the price or terms of the purchase.

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Property Law Issues with MCAs

- Can you sell (and transfer property rights in) something that doesn't exist yet?
- Basic property law: "an assignee can acquire no greater rights than those possessed by the assignor himself." *Alderman Interior Systems, Inc. v. First National-Heller Factors, Inc.*, 376 So. 2d 22, 24 (Fla. 2d DCA 1979).
- "[A]n assignee never stands in any better position than his assignor." *Int'l Ribbon Mills, Ltd. v. Arjan Ribbons, Inc.*, 36 N.Y.2d 121, 126, 325 N.E.2d 137 (N.Y. 1975).
- The Restatement of Contracts: "A contract to make a future assignment of a right, or to transfer proceeds to be received in the future by the promisor, is not an assignment." Restatement (Second) of Contracts § 330 (1981).

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Chapter 11 Bankruptcy Implications

- Why do many MCA companies ignore chapter 11 debtors?

- Cash collateral
  - How do MCA Companies approach cash collateral?
  - How does the MCA company's "ownership" of future receivables or receipts factor into cash collateral?

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Cash Collateral

- Cash collateral issues arise when a merchant's cash advance has been made to an entity that ends up in bankruptcy.
- Characterization of the merchant cash advance transaction is critical.
  - Accounts receivable/income stream are property of the estate.
  - Accounts receivable/income stream are not property of the estate.
- Accounts receivable may have already been pledged to a conventional/non-MCA lender so that the accounts receivable may be fully encumbered to a prior perfected third party lender.
  - If this is the case, the MCA may not have standing to assert claims to cash collateral. *In re Newcare Health Corp.*, 244 B.R. 167, 170 (B.A.P. 1st Cir. 2000).

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MCA vs. Senior Secured Lender

- *In re Brooks*, 619 B.R. 669 (Bankr. C.D. Ill. 2020)
- **UCC § 9-315 SECURED PARTY'S RIGHTS ON DISPOSITION OF COLLATERAL AND IN PROCEEDS**
- **(a) [Disposition of collateral: continuation of security interest or agricultural lien; proceeds.]**
- Except as otherwise provided in this article and in Section 2-403(2):
- (1) a security interest or agricultural lien continues in collateral notwithstanding sale, lease, license, exchange, or other disposition thereof unless the secured party authorized the disposition free of the security interest or agricultural lien; and
- (2) a security interest attaches to any identifiable proceeds of collateral.

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Other Chapter 11 Issues

- 11 U.S.C. § 552
  - (a)Except as provided in subsection (b) of this section, property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.

- The debtor has an argument under § 552 of the Bankruptcy Code that accounts receivable generated post-petition are not subject to the claimed interest of an MCA.
  - *In re Cross Baking Co., Inc.*, 818 F.2d 1027, 1029 (1st Cir. 1987).
- To the extent an MCA agreement purports to buy receivables not yet in existence, that helps the debtor under § 552(a) of the Bankruptcy Code.

- Can an MCA agreement be an executory contract under 11 U.S.C. § 365?

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Avoidance Actions

- Constructively Fraudulent Transfers
  - Some MCA advances represent a large difference between the amount advanced relative to the amount received, so that there might be a claim that the sale of accounts receivable/income stream was not for "reasonably equivalent value," making it constructively fraudulent.
  - The focus of at least two courts have been whether the amount paid to the MCA was reasonably equivalent to the amount that the MCA advanced to the merchant rather than on the amount of receivables/income stream sold to the MCA.
    - *GMI Group, Inc. v. Unique Funding Solutions, LLC* (*In re GMI Grp., Inc.*), 606 B.R. 467, 495 (Bankr. N.D. Ga. 2019).
    - *GMI Group, Inc. v. Reliable Fast Cash, LLC* (*In re GMI Grp., Inc.*), 2019 WL 3774117 (Bankr. N.D. Ga. 2019).

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Avoidance Actions

- Preferential Transfers
  - Preferences would appear to be much harder to successfully litigate than perhaps constructively fraudulent conveyances because one element of a preferential transfer is that the transfer must have been "for or on account of an antecedent debt."
  - As is the case with most MCA analyses, whether the transaction involved is a loan or a sale of accounts receivable/income stream goes a long way in determining whether or not payments made as a result of the transaction could be clawed back as preferences.
  - And, if the transaction is characterized as a sale and not a loan or a secured transaction, one of the fundamental elements of a preferential transfer cause of action is lacking.
  - However, if the transaction is characterized as a loan or a secured transaction, typical preferential transfer analysis will then be appropriate, especially if there is a prior, properly perfected security interest, to a third party, in the debtor's accounts receivable.

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Practical Experience – Negotiating with MCAs

- Subchapter V Trustee perspective
- Debtor perspective
- MCA company perspective
- Corporate Sub V Circuits weigh in

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Discharge/Dischargeability in Corporate Subchapter V Cases

- Discharge litigation in "legacy" Chapter 11 cases does not occur because 11 U.S.C. § 523 was limited in its coverage to individuals, and not to corporations.

- However, the statutory language of Subchapter V with respect to discharges (occasionally described as "awkward") leaves open the issue of whether or not discharge litigation could be brought against a corporate debtor in a Subchapter V case.

- Substantially all of the lower courts considering the issue ruled that discharges apply only to individual cases and not to corporate Subchapter V cases.

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Discharge/Dischargeability in Corporate Subchapter V Cases

- The Fourth Circuit, however, in *Cantwell-Cleary Co., Inc. v. Cleary Packaging, LLC* (*In re Clear Packaging, LLC*), 36 F.4th 509 (4th Cir. 2022), ruled to the contrary and found that "[w]hile the question is a close one," it disagreed with the trial court and ruled that all Subchapter V debtors are subject to the discharge limitations described in 11 U.S.C. § 523(a) and not just individual Subchapter V debtors. *Id*. at 512.
- The court dissected the applicable statutory sections and found that "any" tension between the language of § 523(a) addressing individual debtors and the language of § 1192(2) addressing both individual and corporate debtors, that the more specific provisions should govern over the general.
- So, while § 523(a) refers to a number of discharge provisions of the Bankruptcy Code, § 1192(2) is more specific, and addresses only Subchapter V discharges.
- Again, while noticing the language might be "clumsy," the court also found that the abrogation of the absolute priority rule in Subchapter V was a bargain for "give" that justified, from an equitable standpoint, including corporations within the coverage of § 523(a) of the Bankruptcy Code.
- The Fifth Circuit agreed with the Fourth Circuit in *Avion Funding, L.L.C. v. GFS Indus., L.L.C.* (*In the Matter of GFS Indus., L.L.C.*), 99 F.4th 223 (5th Cir. 2024).

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Guarantee Issues

- Individual Guarantor Exposure

- Nondischargeability Issues
  - Section 523(a)(2)(4) and (6)
  - Stacking
  - Other covenants
  - Trust/fund/embezzlement

- *In re Daddosio*, 2023 WL 5355265 (Bankr. N.D. Ill. Aug. 21, 2023)
  - Debt nondischargeable under 523(a)(4) and (a)(6) when debtor sold assets covered by MCA company's blanket lien without providing proceeds to MCA company

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Closing Thoughts and Questions