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Client Alert

Receivables Transactions Revisited: Recent Decisions Split on Sale vs. Loan Characterization

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The merchant cash advance ("MCA") industry recently provided two different bankruptcy courts with an opportunity to consider the characterization of MCA funding transactions as either "true sales" of receivables or "disguised loans". [1] MCA funders typically provide cash to a financially distressed company in exchange for a percentage of that company's future receivables collection. Companies in need of liquidity will often seek to monetize their receivables, either by selling them (*i.e.*, a true sale) or using them as collateral for a loan (*i.e.*, a secured loan). Recognizing the benefits of having an ownership interest in such assets in case of a counterparty's bankruptcy, MCA funders typically attempt to structure their transactions as "purchases" of a company's future receivables. For that same reason, a bankruptcy trustee or a debtor-in-possession will often argue that these transactions are really "disguised loans" and that the MCA funder is only a secured creditor of the bankruptcy estate that owns the receivable.

The characterization of a funding transaction has significant implications in a bankruptcy proceeding. If characterized as a true sale, the receivables purchased are not property of the seller's bankruptcy estate and the automatic stay would not prevent the funder from post-petition collections. If characterized as a secured loan, however, the funder would have only a security interest in the receivables, would be subject to the automatic stay and potentially subject to other competing secured creditor claims and priorities. Of further concern to purchasers if characterized as a loan, the transaction may be subject to and scrutinized under the applicable jurisdiction's usury laws, an issue not typically of concern in the context of a true sale. Accordingly, many receivables purchase transactions have the superficial characteristics of a sale, *e.g*., the documents state that transaction is, and the parties intend it to be a true sale. Nonetheless, many of these transactions also include terms more characteristic of a loan, blurring the fine line between the two under the guise of protecting the funder against an adverse ruling on characterization.

Courts have developed a holistic, multifactor framework to determine whether a transaction should be treated as a true sale or a financing which extend beyond the stated intent of the parties set forth in the transaction documents. No single factor is determinative and the analysis is highly contextual. Both the *R&J Pizza* and *Shoot the Moon* cases demonstrate how specific factors can affect the characterization analysis, and should prompt any funder to pay close attention to how their transaction documents are drafted and how they conduct their business dealings in connection with the ongoing administration of the transaction. Each court examined similar factors to reach their respective decisions, yet they reached opposite conclusions. In *R&J Pizza*, the court protected the funder and held that the transactions were true sales. While in *Shoot the Moon*, the court protected the seller of receivables and held that the receivables transaction was a secured loan. The lessons that funders can take from the *Shoot the Moon* funder's mistakes may prove to be valuable.

Background of the Cases

In *Shoot the Moon,* CapCall, LLC ("CapCall"), an MCA funder, and Shoot the Moon and its subsidiaries ("Shoot the Moon"), entered into eighteen separate "merchant agreements" pursuant to which CapCall agreed to provide Shoot the Moon with immediate cash in exchange for a portion of future receivables collections derived from Shoot the Moon's restaurant operations. The payment of those receivables to CapCall were effectuated by ACH debits in the amount specified in the various merchant agreements against specified Shoot the Moon owned bank accounts. These payments were to continue until CapCall received the full purchase amount plus a generous return on its investment. The majority of the ACH payments were made from a bank account in the name of a single subsidiary that was not a party to the any of the merchant agreements and was not involved in the restaurant operations. At the time of Shoot the Moon's bankruptcy, certain amounts remained in the segregated account consisting of customer credit card payments that were processed prepetition but transferred to the account post-petition. Following the bankruptcy filing, CapCall sought a declaratory judgment that the transactions were true sales and therefore, it owned the balance held in the segregated account. The bankruptcy trustee counterclaimed, seeking a ruling that the transactions were instead disguised loans, and further sought relief to obtain unencumbered rights to the segregated account and the funds in the account. The Court determined that the transactions were secured loans and further found that these transactions violated the applicable state's usury laws.

In *R&J Pizza*, Merchant Cash & Capital, LLC, a MCA provider ("MCC"), and R&J Pizza Corporation ("R&J Pizza") entered into various purchase agreements pursuant to which R&J Pizza sold and MCC purchased an undivided interest in future receivables at a discount from face value (the "Purchased Amount"), which included debit, credit and other bank card payments due to R&J Pizza, until the aggregate total of the Purchased Amount was paid in full. The parties also contemporaneously entered into a credit card processing agreement with Newtek Merchant Solutions ("Newtek") to help direct the cash attributable to the purchased receivables directly to MCC. The following year, MCC and R&J Pizza entered into a modification agreement pursuant to which MCC agreed to purchase additional accounts from R&J until the Purchased Amount had been paid in full. There was no right to charge or collect interest regardless of how long it took for MCC to collect the Purchased Amount. After the petition date, R&J Pizza retained a new processor without MCC's knowledge or consent and failed to instruct the new processor to transfer cash that was allegedly owed to MCC pursuant to the purchase agreements. MCC argued that the unpaid portion was its property and not property of the debtor's estate. The Court ultimately determined that the transactions were true sales and that R&J Pizza retained no rights in the purchased receivables.

Factors Considered and Analyzed in Each Case

A. Language of the Transaction Documents

<u>Shoot the Moon</u>

- The merchant agreements included lengthy provisions stating that the transactions were not intended to be loans but rather purchases of receipts for an amount that equals the fair market value of the

receipts. However, the Court explained that simply designating a transaction as a "sale" does not change the nature of the transaction and held that those provisions were only "self-serving" and "conclusory."

- The transaction documents included broad granting clauses, which granted to CapCall "a security interest in all…payment and general intangibles" and "all proceeds" – language more characteristic of a loan secured by multiple asset classes rather than that of a true sale of receivables. The Court explained that in a true sale context, CapCall should have been granted no more than a protective security interest in the accounts that it purportedly purchased, and not in the broader range of assets granted under the agreements.

- CapCall identified Shoot the Moon as a "debtor" on its financing statements rather than as a "seller", although most state financing statement forms include the option to refer to the "debtor" as the "seller" and the "secured party" as the "buyer".

R&J Pizza

- The purchase agreements did not expressly grant MCC a security interest in receivables (or any other assets for that matter). Rather, the Court found that the parties acknowledged and agreed that the "purchase price' paid by MCC in exchange for the Purchased Amount of future credit card receivables was a "sale" of the Purchased Amount and is not intended to be nor should be construed as a loan.

- The purchase agreements consistently referred to the transaction as a "sale" and "purchase" and referred to the parties of the transaction as "seller" and "purchaser". The financing statement filed by MCC described the transaction as a "purchase" and "sale", as further evidenced by the following language: "The sale of future receivables pursuant to the Agreement is intended by the parties thereto to be an outright sale of such future receivables and not intended to be, nor is it to be construed as, a financing or an assignment for securing the obligations of the seller..."

B.Rights and Recourse

Shoot the Moon

- The rights, recourse and other various protections against default afforded to CapCall, along with the great risk allocated to Shoot the Moon, were characteristic of a debtor-creditor relationship. The Court found that CapCall was protected with rights that went far beyond its rights in the receivables. The merchant agreements and financing statements granted CapCall security interests in other assets beyond the receivables such as the restaurants' inventory, equipment and service marks. Some additional protections included: (i) a broad personal guarantee of performance and payment by Shoot the Moon and other guarantors: (ii) broad rights of power of attorney: and (iii) the right to debit any of Shoot the Moon's deposit accounts.

- While the Court acknowledged that the absence of any repurchase provisions or provisions allowing Shoot the Moon to alter the price terms was a factor that supported CapCall's true sale position, the

Court found that this did not outweigh other factors, explaining that it would be rare for all of the factors in a transaction of this type to point in the same direction.

R&J

- There were no recourse provisions against the debtor for non-collection in the purchase agreements. The Court stated that the purchase agreements "expressly provide" that the debtor had no right to repurchase the purchased credit card receivables.

- While there was a personal guarantee of the debtor's principal, there were only very limited circumstances where MCC would have rights thereunder (limited to non-credit related affirmative acts and factual misrepresentations).

C. Course of Performance and Dealings

Shoot the Moon

- The Court found that the course of dealing between the parties was characteristic of a loan. The discussions between the parties often involved dialogue typically reserved for a debtor-creditor relationship, including references to "loans", "terms" and "balances".

- The Court found that the "stacking" or "rolling" of funds from one transaction to the next and the commingling of funds by Shoot the Moon with CapCall's knowledge was characteristic of a loan transaction. It explained that this practice would only be practical in the loan context because in the sale context it would require CapCall to continuously rebuy and resell future receivables.

R&J

- The Court found that R&J Pizza did not retain any rights to process or commingle the proceeds. R&J Pizza was required to use a credit card processor that was designated as the sole processor and retained no right to collect on the card receivables.

Implications

The decisions in these cases provide important guidance to receivables funders on how to limit the risk that their transaction will be recharacterization as a loan. The following are several key takeaways to mitigate recharacterization risk:

1. Avoid the use of broad granting clauses that convey a "security interest" in the seller's assets and limit any grant of a security interest solely as a fallback measure should the transaction be recharacterized as a loan.

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2. Identify each seller of receivables as a “seller” not a “debtor” in the financing statements (check the “Seller/Buyer” box on the UCC-1) and in other related transaction documents and avoid using terms generally associated with secured loan transactions in communications and documents..
3. When drafting the recourse and collection provisions, limit recourse to the representations and warranties at the time of sale, focusing on the condition of the assets being sold.
4. Carefully examine how the risks are allocated between the seller and buyer when structuring the transaction and drafting transaction documents as courts consider this factor heavily in their true sale analysis. Generally, if the credit recourse is allocated to the seller or any guarantors, the greater the likelihood a court will classify the transaction as a secured loan rather than a true sale.
5. If the Seller is also collecting and servicing the purchased receivers on behalf of the buyer, transaction documents should unequivocally prohibit the seller from commingling collections on purchased receivables with other collections which are proceeds of the purchased receivables.

Purchasers of receivables should take note of CapCall’s missteps, some of which are more obvious than others. The alternative is to assess the risk that a transaction, which seems to make commercial sense at the time of closing, will be subject to a fact-intensive investigation, potentially leading to a re-characterization of the transaction as a loan should the originator of the receivables find itself in a bankruptcy proceeding.

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[1] *Cap Call, LLC v. Foster (In re Shoot The Moon, LLC), 2:15-bk-60979-WLH (Bankr. D. Mont. Sep. 10, 2021) and In re R&J Pizza Corp., Case No.: 14-43066-CEC (Bankr. E.D.N.Y. Oct. 14, 2020).*

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