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When Is A Working Capital Agreement A Loan? It Depends

By **Benjamin Jackson and Muhammad Faridi**

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Suppose you've entered into a financial arrangement to obtain working capital. The agreement resembles a loan agreement, but it is not formally designated as such, and you think the cost of capital is too high. After negotiations to reduce the cost fail, it becomes clear that litigation is your only potential path out of the agreement. Do you sue for misrepresentation on the grounds that you thought you were getting a loan, or do you sue on the theory that the agreement is, in fact, a loan agreement but is usurious and therefore unlawful?

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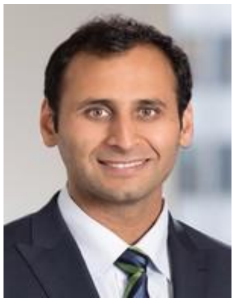

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In a recent case, plaintiffs tried both strategies and prevailed, at least in part. In K9 Bytes Inc. v. Arch Capital Funding LLC, No. 54755/16, 2017 NY Slip Op 27166, 2017 N.Y. Misc. LEXIS 1903 (Sup. Ct. Westchester Cty. May 4), Justice Linda S. Jamieson of the Commercial Division ruled that, if a contract expressly purports not to be a loan agreement, a plaintiff cannot allege that it was misled because it thought that it was entering a loan agreement. The court must look to the substantive provisions of the agreement to determine whether, as a matter of law, the agreement is a loan agreement and therefore subject to usury laws. Because the agreements at issue expressly purported not to be loan agreements, the court dismissed the plaintiffs' misrepresentation claims, but allowed certain of the plaintiffs' usury claims and claims under the Racketeer Influenced and Corrupt Organizations Act to go forward because, according to the court, one of the two agreements at issue might, in substance, be a loan agreement.

K9 Bytes raises several important issues for working capital providers, businesses that have entered into working capital agreements, and their lawyers. First, can working capital agreements, notwithstanding the fact that they are labeled as such, be subject to New York's usury laws if they substantively resemble loan agreements? Second, do reconciliation provisions, finite terms relating to repayment, and recourse in bankruptcy have any bearing on whether the agreements are deemed working capital agreements or loan agreements?

Factual and Procedural Background

The case involved two separate plaintiffs and two separate agreements, each with slightly different terms. The defendants, Arch Capital Funding LLC and Cap Call LLC, provide working capital to businesses via contracts that are designated as "merchant agreements."[1] In 2015 and 2016, certain of the plaintiffs entered into agreements with Arch, under which Arch gave them $166,000 in exchange for future receivables worth $241,334. The agreements provided that Arch could take no more than 13-15 percent of a given day's receivables, or alternatively a set daily amount, and also stated that payments to Arch would be conditioned upon the plaintiffs' receiving payment from their customers for sales. The agreements provided for an automatic renewal term of one year, referred to as an "evergreen" provision.

The agreements at issue also contained a "reconciliation provision" that provided the plaintiffs with some flexibility as to when to repay Arch.[2] A reconciliation provision typically allows a merchant to seek an adjustment of the amounts being taken out of its account based on its cash flow. For instance, if the merchant is doing poorly, the merchant pays less and receives a refund of anything taken by the funding company exceeding a specified percentage, which can often be adjusted downward. If the merchant is doing well, the merchant will pay more than the daily amount to reach the specific percentage.[3]

In February 2016, plaintiff Epazz Inc. and Cap Call entered into a separate agreement under which Cap Call gave Epazz $120,000 in exchange for future receivables of $179,880. This agreement provided that Cap Call could take no more than 15 percent of daily receipts, or a fixed daily amount of $1,635, and it also provided that the receipts shall be from settlement amounts due to Epazz from electronic check transactions or payment processing transactions. Like the Arch agreement, the Cap Call agreement had an evergreen provision, but unlike the Arch agreement, it did not contain a reconciliation provision.[4]

Although it is not entirely clear from the face of the ruling, it appears that both Arch and Cap Call obtained confessions of judgment from the plaintiffs.[5] Under New York's CPLR 3218, a confession of judgment is an affidavit in which a debtor admits liability to a creditor for a specified amount of monetary damages, and agrees that the affidavit can be filed as a judgment if a specified condition (typically a default) occurs.

According to the ruling, the plaintiffs breached the agreements[6] in March 2016, and sued the defendants, asserting that the agreements were unlawful because they were usurious loan agreements, and that therefore the confessions of judgment should be vacated. Arch and Cap Call moved to dismiss.[7]

Discussion

Justice Jamieson began by addressing several causes of action based on misrepresentation, unilateral mistake, unconscionability, prima facie tort and Licensed Lender Law § 340.

First, Justice Jamieson rejected the plaintiffs' claim that the defendants misled them by representing that they were entering into loan agreements, reasoning that the agreements clearly had the phrases "Merchant Agreement" and "Purchase and Sale of Future Receivables" written in their headings.[8] For this reason, the "plaintiffs had the means to understand that the agreements set forth that they were not loans," and they could not assert that they had been misled.[9]

Next, Justice Jamieson rejected the plaintiffs' unconscionability claim, reasoning that "unconscionability is not a claim, but a defense."[10] Justice Jamieson then dismissed the plaintiffs' cause of action seeking damages for prima facie tort, on the grounds that there is no recovery in prima facie tort unless malevolence is the sole motive for the defendant's otherwise lawful act, and here it was clear that the defendants' sole motivation was profit or greed, not "disinterested malevolence."[11] Justice Jamieson also dismissed the plaintiffs' Licensed Lender Law § 340 claim because there were no allegations that the defendants are in the business of making loans to individuals.[12]

Next, Justice Jamieson turned her attention to the portion of the defendants' motion seeking dismissal of the plaintiffs' cause of action to vacate confessions of judgment because of usury and the plaintiffs' RICO claims, which "turn[ed] on whether or not the agreements are usurious."[13]

According to the court, usury laws apply only to loans or forbearances, and not to other forms of contractual arrangements, however unconscionable they may be. The court noted that, under New York law, there is a presumption that a transaction is not usurious, and consequently claims of usury must be proven by clear and convincing evidence. The court stated that an agreement is more likely to be determined to be a loan, as opposed to a purchase of receivables, if: (1) it does not contain a reconciliation provision; (2) it has a finite term; and (3) if the party providing the funds upfront has recourse in case the party receiving the upfront funds declares bankruptcy.[14]

Applying these factors here, the court found: (1) the Arch agreements provided for reconciliation, but the Cap Call agreement did not; (2) the Arch agreements and the Cap call agreement had indefinite terms; and (3) the Arch agreements did not state that bankruptcy was a basis for declaring a default,[15] while the Cap Call agreement did.[16]

Justice Jamieson found the Arch agreements to be "sufficiently risky such that they cannot be considered loans, as a matter of law," as "[u]nder no circumstances could Arch be assured of repayment, because its agreements are contingent on a merchant's success, and the term is indefinite."[17] The court accordingly dismissed the usury claims against Arch in their entirety.

However, because the Cap Call agreement "remove[d] much of the risk from the calculation," Justice Jamieson refused to conclude as a matter of law that the Cap Call transaction was not a loan.[18]

As to the RICO claims, Justice Jamieson explained that a RICO claim "requires that a defendant do one of two things: either (1) have collected an unlawful debt; or (2) engaged in a pattern of racketeering activity." The court noted that the plaintiffs had not sufficiently alleged a pattern of racketeering activity, and since the court determined that Arch did not collect an unlawful debt, Arch could not be liable under RICO. However, the court held that the RICO claims against Cap Call could move forward to the extent they were based on Cap Call's alleged collection of an unlawful debt.[19]

Conclusion

K9 Bytes held that if a contract expressly purports not to be a loan agreement, a plaintiff cannot allege that they were misled because they thought they were indeed entering a loan agreement. However, the court must look to the substantive provisions of the agreement to determine whether, as a matter of law, that agreement is subject to usury laws. The decision demonstrates several key lessons for providers and receivers of working capital alike.

Drafters of working capital agreements should be aware that there is now at least one court ruling holding that if the terms of a working capital agreement resemble those of a loan agreement, then it will likely be treated as such (at least under this fact pattern), regardless of what the agreement calls itself. Drafters should be mindful of the consequences of including a reconciliation provision in these agreements, giving the agreements indefinite terms, and specifying the rights and remedies afforded to the working capital provider in the event the business files for bankruptcy protection.

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[1] 2017 N.Y. Misc. LEXIS 1743 at *1.

[2] See id. at *1.

[3] Id. at *12.

[4] Id. at *2-3.

[5] See id. at *3-4, *14.

[6] The opinion does not specify how the plaintiffs breached the agreements.

[7] Id. at *3.

[8] Id. at *4-5.

[9] Id. at *6.

[10] Id. at *7.

[11] Id. at *8.

[12] Id. at *8-9.

[13] Id. at *10. In addition to addressing these causes of action, Justice Jamieson dismissed a cause of action seeking judgment against defendants based on usury and a cause of action seeking judgment based on an overcharge of interest on the grounds that “criminal usury may only be asserted as a defense by a corporation, and never as a means to seek affirmative relief.” Id. at *9-10.

[14] See id. at *12-15.

[15] The Arch agreements did, however, state that should the merchant file for bankruptcy, a personal guaranty could be enforced and Arch could file a confession of judgment.

[16] Id. at *13-15.

[17] Id. at *15.

[18] Id. at *17.

[19] Id. at *16-17.