A “Sale” of Future Receivables:
Criminal Usury in Another Form

John F. Hilson &
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In our article in the April issue of this newsletter,¹ we attempted to show that transactions in which a financier purports to buy a fixed percentage of the future receivables of a business, and then collects each day either a specified amount or specified percentage of receipts until the financier receives a specified total, are really loans. Nevertheless, courts continue to rule that many – but not all – such transactions are not loans for the purposes of New York’s criminal usury statute.² This follow-up article explores more fully why most of those decisions are wrong and their analysis is misguided.

Background on Sales vs. Loans

Before delving into the details of New York law, it is useful to explore the distinction between a sale and a collateralized loan. In a pure sale of an asset, all of the attributes of ownership shift from the seller to buyer. Chief among these attributes are the right to the benefit of appreciation, the risk of loss or depreciation, the right to control or possess the asset, and the right to transfer the asset to others. In general,³ this is true regardless of the nature of the asset. The buyer of a vehicle, a painting, shares of stock in a corporation, or a receivable acquires all of these things.

Focusing on receivables, consider a buyer who pays $8,000 for a receivable with a face amount of $10,000. Of course, as is true with respect to any property that is sold, the receivable might be worth more or less than the purchase price at the time of the transaction. The potential gain or loss from such a discrepancy now falls on the buyer. More importantly, if the receivable appreciates – as it might, for example, if the receivable bears interest at a fixed rate and market interest rates decline – the buyer can realize that benefit by reselling the receivable. If the receivable depreciates – as it might if interest rates rise or the obligor becomes insolvent – the buyer suffers the loss. Finally, the buyer is now the person who can exercise rights associated with the receivable: accelerate the debt after a default, bring a collection action, or agree to a modification with the obligor.

Now consider a transaction in which the owner of a $10,000 receivable uses the receivable as collateral for an $8,000 loan. In the normal course of events, the lender acquires none of the attributes of ownership. If the receivable appreciates, the loan might be more secure, but the lender receives no direct benefit from the appreciation. That benefit inures to the borrower. If the receivable depreciates, the loan becomes less secure, but the borrower remains liable for the full amount of the debt. Finally, the borrower retains the rights to accelerate after default, sue to collect, and agree to a modification.⁴

But this stark contrast between a sale and a loan is somewhat illusory. They are instead merely the two endpoints on a continuum of possibilities:

In other words, the parties can by their agreement transfer only some of these attributes of ownership. For example, a seller might retain the right and the responsibility to service the receivable – that is, to collect and enforce it – even though the buyer acquires the benefit of appreciation and the risk of loss or depreciation. Alternatively, the parties can allocate between themselves the benefit of appreciation and the risk of loss, with one of them getting the former and the other the latter. In a non-recourse, secured loan, for example, the borrower does not retain the risk of loss or depreciation. The following chart summarizes the possibilities (using the terms “original owner” and “transferee” throughout, to avoid confusion and more readily illustrate the differences):
These possibilities can be further refined by structuring the transaction to transfer only a portion of the benefit of appreciation or only a portion of the risk of loss.

Fortunately, when the attributes of ownership are divided, for some purposes it does not matter whether the transaction is characterized as a loan or a sale. For example, Article 9 of the Uniform Commercial Code generally applies to both a loan secured by receivables and a sale of receivables, as well as to all the variations in between. Usury law, in contrast, applies only to loans (and in some cases to other extensions of credit); it does not apply to sales. For this purpose, therefore, courts have had to distinguish sales from loans, and they understandably have struggled to do so when confronted with transactions that bear some resemblance to each.

**Background on Criminal Usury in New York**

In general, in New York, loans that bear interest in excess of 16% are usurious under civil law, and those that charge interest in excess of 25% per year are criminally usurious. Subject to several exceptions, usurious contracts are void. The consequences to the lender if a transaction is usurious are rather harsh: the borrower is relieved of all further obligation to pay not only interest but also outstanding principal – and any liens securing payment are canceled. In effect, the borrower can simply keep the borrowed funds and walk away from the agreement. Moreover, the borrower can recover any interest payments made in excess of the applicable maximum rate.

However, numerous statutory and judicial exceptions mitigate this harshness. Corporations are generally ineligible to raise a defense based on civil usury, although they can raise a defense based on criminal usury. Banks charging a usurious rate forfeit interest but not principal. Moreover, a usury defense can be waived or the borrower can be estopped from asserting it.

Perhaps most importantly, courts have developed a variety of rules to distinguish lending transactions subject to usury restrictions from other sorts of financing arrangements that are not. For example, a litigation funding arrangement in which the financier is to be paid only out of the proceeds of the litigation, if any, is deemed to be a transfer of an ownership interest in the proceeds of the litigated claim, rather than a loan, and hence is not subject to the prohibitions on usury.

Courts have reached this conclusion regarding litigation funding arrangements in large measure after reasoning from a more general premise stated three-quarters of a century ago in *Rubenstein v Small*: for a transaction to constitute a loan, “it is essential to provide for repayment absolutely.” In reliance on this premise, New York courts have distinguished between transactions supported by a guaranty and those that are not. Specifically, a sale of future receivables supported by a guaranty that imposes liability regardless of the reason for nonpayment can be usurious, whereas such a transaction supported by a very limited guaranty or by no guaranty at all is treated as an investment, the return on which is contingent on the success of the business. As a result, the transaction is not a loan and cannot be usurious.

Even if a sale of future receivables includes a guaranty or is otherwise structured so that liability is absolute, New York courts will still normally treat the transaction as a sale, rather than as a loan, unless there is: (i) a definite term; and (ii) no “reconciliation provision,” a term discussed below.

**Critique of New York Usury Law**

Much of the courts’ analysis is misguided. Let us begin with the oft-stated requirement that there must be some absolute repayment obligation for a transaction to constitute a loan. There are at least five reasons why that requirement is at least questionable, if not outright wrong.

First, the quoted line from *Rubenstein* is not part of the court’s holding or even its reasoning, and thus is the weakest form of dicta. The *Rubenstein* case did not involve a claim of usury. Nor was it about whether a financial transaction structured as something other than a loan should be re-characterized as a loan. In fact, it was the reverse: whether a transaction structured as a loan to finance a theatrical production – but which provided for payment of a percentage of net revenue, rather than interest – was sufficiently like a partnership agreement so as to entitle the financier to an accounting. Quite frankly, nothing about the court’s decision really stands for the proposition that without absolute personal liability, there is no loan.
Second, if the requirement of absolute liability were taken literally, then a non-recourse loan would not be treated as a loan for the purposes of usury. Even an over-secured, non-recourse loan would be exempt from the protections against usury. But there is no good reason why that should be the case. Indeed, policy dictates quite the opposite approach. Interest is designed to compensate for both the time value of money and the risk of nonpayment. If a loan is heavily over-secured, then all other things being equal, this should lead to a lower interest rate and make the charging of usurious interest even more egregious.

Third, if usury laws ceased to apply merely because the transaction documents specify a contingency that absolves the financier’s client of liability, then it would be very easy for lenders to evade the prohibitions on usury. They could simply include in the transaction documents a clause providing that no further payment is due after a nuclear war or meteorite strike disrupts the client’s business (when, by the way, the financier would have far weightier things to deal with than recovering the amount advanced). This would allow form to rule over substance and seriously undermine the restrictions on usury. It is unlikely that the courts would countenance such an artifice. In short, courts do not really believe the dicta from Rubenstein, and thus their repeated citation to it does not support their position.

Fourth, even if the search for some absolute payment obligation makes sense in some contexts, it does not in transactions involving a purported sale of a fraction of future receivables. In the litigation funding scenario, for example, in which the financier is to be repaid only from the proceeds of the litigation, the financier accepts a risk completely unrelated to the creditworthiness of its client. The high rate of return that the transaction typically calls for compensates for that risk. It makes some sense, therefore, to exempt that rate of return from the restrictions on usury – and also makes some sense to remove that exemption if the client promises to repay the advance regardless of the results of the litigation.

In a sale of future receivables, however, the risk that there will be no receivables from which to extract payment is not appreciably different from the risks associated with the creditworthiness of the client. In other words, if a business ceases to generate income, it can neither repay a true loan nor return an advance against future receivables. The risk is essentially the same. Moreover, it is the risk that interest rates traditionally compensate for, and hence a risk that should not exempt the financier from usury laws.

Finally, if adding a guaranty makes a transaction a loan, then the guaranty ceases to be merely a promise to perform a stated obligation; it is instead something that actually transforms the obligation. That is not what guaranties normally do.

Let us now examine the other factors courts tend to cite when concluding that a sale of future receivables is not a usurious loan: the lack of a definite term and the presence of a reconciliation clause. Properly understood, these factors have no bearing on whether the transaction is a loan, but they might affect whether the transaction is usurious.

Consider first the lack of a definite term. Nothing about a loan transaction requires that it have a fixed term. Indeed, the U.C.C. expressly provides that a negotiable promissory note can provide for payment on demand, and certainly a negotiable demand note providing for interest at a rate in excess of 25% would be usurious under New York law. Thus, the absence of a fixed term does not, by itself, mean that a transaction is not a loan.

The same is true for a so-called “reconciliation provision.” In most transactions involving a sale of future receivables, the financier pays a “Purchase Price” in return for a “Specified Percentage” of the business’s future receipts until the “Purchased Amount” is repaid. The agreements provide for the financier to automatically debit the business’s deposit account by a specified amount each day or each business day. Obviously, the specified amount might or might not equal the “Specified Percentage” of receipts on any given day. If the agreement contains a reconciliation provision, then at specified intervals, either automatically or at the request of the business, the parties will review past receipts and payments to determine if the sum of the daily payments totaled more than what the Specified Percentage should have yielded and, if so, require reimbursement of the excess. In short, a reconciliation clause ensures that the business is really paying a percentage of its receipts rather than a fixed amount.

Courts regard this difference in how the financier is compensated as relevant for two interrelated reasons. First, if the financier is receiving a percentage of receipts, then the financier has a bit more risk and the transaction more closely resembles a purchase of the receivables than a loan. Of course, that resemblance is belied by the fact that the financier remains entitled to payments until it receives the Purchased Amount, so the financier really has few or none of the attributes of ownership of any particular receivable or set of receivables. Second, if the financier is entitled to a fixed amount each day, then it is easy to determine how long it will take for the business to fully pay the Purchased Amount, and from that to calculate the effective interest rate on the advance. If, however, the financier is really entitled to receive a percentage of receipts, it becomes difficult or impossible to predict how long it will take for the business to fully pay the Purchased Amount, and thus difficult or impossible to calculate the effective interest rate.

But none of this should have any bearing on whether the transaction is a loan. At most it affects what the interest rate is. A fixed payment schedule leads to a determinable interest rate. A variable payment means the interest rate is indeterminate (and the longer payment takes, the lower the financier’s rate of return). Given the severity of the penalties for usury, courts are
justifiably concerned about the uncertainty in ascertaining the financier’s rate of return.\textsuperscript{22}

But this legitimate concern should not obscure the reality that in many sales of future receivables, the effective rate of return is so far above the rate for criminal usury that the usurious nature of the transaction cannot truly be doubted. Even if, as is true in New York, the borrower has the burden of proving that a loan is usurious,\textsuperscript{23} courts should not allow a highly unlikely contingency to deprive borrowers of the protection that usury law is intended to provide. A loan that is usurious except when pigs fly, is usurious.

\textbf{CONCLUDING THOUGHTS & ADVICE}

We have spent much of our professional lives representing creditors. We believe that freely available credit is vital to both the national and global economies, a proposition readily confirmed by the financial crisis of a decade ago. We also believe in the memorable line from the movie \textit{Repo Man} that “credit is a sacred trust”; borrowers should pay their debts. Finally, we are more than willing to question the desirability of restrictions on usury, something Jeremy Bentham famously and ably did more than two centuries ago.\textsuperscript{24} But if the law is going to prohibit usury, it should do so effectively.

It is impossible to predict whether the points we have made above will ever persuade courts to alter their analysis and application of New York usury law.\textsuperscript{25} Nevertheless, we believe that transactions structured as a sale of a percentage of future receivables are often usurious and hence are more risky for the financier than a cursory reading of the cases would suggest. Counsel for those financiers should advise their clients accordingly.

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Notes:


3. The most common exception would probably be if there is a legal or valid contractual restriction on the right to transfer. For example, the buyer of a license to operate a taxicab or casino might not be able to transfer the license without the prior approval of the governmental agency that issued it. The buyer of a membership interest in a limited liability company might not be able to transfer that interest without the prior approval of the other members.

4. Absent an agreement to the contrary, the lender acquires these rights after the borrower’s default. \textit{See} U.C.C. § 9-607.


6. \textit{See}, e.g., DeSimon v. Ogden Associates, \textbf{454 N.Y.S.2d} \textbf{721}, 725 (App. Div. 1982) (“A seller’s extension of credit by demanding a premium (a time-price differential) in the amount representing the difference between a cash and credit price is not considered to be a loan of money for usury purposes.”).


12. \textit{N.Y. Gen. Oblig. Law} § 5-521(1), (3). Even in a criminally usurious transaction, a corporate borrower may raise the issue only as an affirmative defense; it may not use the usurious nature of the transaction as the basis for an affirmative claim. \textit{See}, e.g., K9 Bytes, Inc. v Arch Capital Funding, LLC, \textbf{57 N.Y.S.3d} \textbf{625}, 631 (Sup. Ct. 2017); Colonial Funding Network, Inc. v. Epazz, Inc., \textbf{252 F. Supp. 3d} \textbf{274}, 280 (S.D.N.Y. 2017) (citing cases).


14. \textit{See}, e.g., Hammelburger v. Foursome Inn Corp., \textbf{431 N.E.2d} \textbf{278}, 282–85 (N.Y. 1981) (ruling that estoppel \textit{in pais} applies even to defense of criminal usury). \textit{See also} Seidel, \textbf{598 N.E.2d} \textbf{7} (acknowledging the potential application of waiver and estoppel \textit{in pais} to a usury defense, but concluding neither applied in the case).


For cases dealing with a sale of future receivables, in which the court quoted and relied on this statement, see NY Capital Asset Corp. v. F & B Fuel Oil Co., Inc., \textbf{98 N.Y.S.3d} \textbf{501}, at *6 (Sup. Ct. 2018); Rapid Capital Fin., LLC v. Natures Market Corp., \textbf{66 N.Y.S.3d} \textbf{797}, 800 (Sup. Ct. 2017); Principis Capital,

17. Compare In re Cornerstone Tower Servs., Inc., 2018 WL 6199131, at *6-8 (Bankr. D. Neb. 2018) (an individual guaranty of a sale of future receivables did not make the obligations absolutely repayable because the guaranty was limited and did not cover mere non-collection); Platinum Rapid Funding Group Ltd. v. VIP Limousine Servs., Inc., 2016 WL 6603853 (N.Y. Sup. Ct. 2016) (a guaranty that was no broader than the obligations of the merchant under an agreement to sell future receivables did not make the obligation absolutely repayable), with QFC, LLC v Iron Centurian, LLC, 2017 WL 2989222, at *4 (the requirement of a guarantor demonstrated that the funds provided to purchase receivables were absolutely repayable with calculated interest exceeding the legal rate); Merchant Funding Servs., LLC v Volunteer Pharm. Inc., 44 N.Y.S.3d 876, 881-82 (Sup. Ct. 2016) (a sale of future receivables supported by two guaranties was “absolutely repayable” and a usurious loan); Pearl Capital Rivis Ventures, LLC v. RDN Construction, Inc., 41 N.Y.S.3d 397 (Sup. Ct. 2016) (the presence of an individual guaranty made the principal’s sale of future receivables a usurious loan). See also Clever Ideas, Inc. v 999 Rest. Corp., 2007 WL 3234747 (N.Y. Sup. Ct. 2007) (involving “advance meal sales” and distinguishing an earlier case involving a similar transaction but which lacked an individual guaranty).


In other decisions, courts have avoided direct discussion of whether the transaction documents contain a reconciliation provision by focusing on why such a provision matters: whether the financier is to receive a specified amount each day or a specified percentage of collections. See, e.g., Principis Capital, LLC v Simmons, 2017 WL 4076754 (because a term in the parties’ agreement providing for payment of a fixed percentage of receipts or receivables was superseded by a provision setting a fixed daily payment, a triable issue of fact existed as to whether the transaction was a usurious loan); QFC, LLC v Iron Centurian, LLC, 2017 WL 2989222, at *4 (a term providing for payment of a fixed amount per day superseded a term providing for payment of a specified percentage of collections, resulting in transaction being a usurious loan); Retail Capital, LLC v. Spice Intentions Inc., 2017 WL 123374 (Sup. Ct. 2017) (refusing to treat a purported sale of future receivables as a usurious loan in part because the transaction documents included “a reconciliation on demand provision,” whereby the parties could ensure that the financier collected no more than it was contractually entitled to collect); Merchant Funding Servs., LLC v Volunteer Pharmacy Inc., 44 N.Y.S.3d at 880-81 (because a term in the transaction documents modified the daily percentage to be a specified amount per day, the transaction was a usurious loan); Merchant Cash & Capital v. Transfer Int’l, Inc., 2016 WL 7213444, at *3 (refusing to treat a sale of future receivables as a loan because of the existence of a reconciliation term). See also the discussion of reconciliation provisions, infra page 3.

20. See U.C.C. § 3-104(a)(2). See also § 3-108(a) (defining “payable on demand”).

22. See, e.g., IBIS Capital Group, LLC v. Four Paws Orlando LLC, 2017 WL 1065071, at *4 (“Defendants’ argued interest rate calculations are nothing more than mere speculation based upon assumptions and hypotheses regarding what might have occurred under a very specific set of circumstances”); Merchant Cash & Capital v. Transfer Int’l, Inc., 2016 WL 7213444, at *3 (“defendants’ calculation of ‘interest’ is speculative at best, and rests upon the unwarranted presumption that the daily payment amount is immutable. In view of the foregoing, the Court finds no basis to re-characterize the Agreement as a usurious loan.”).  


24. JEREMY BENTHAM, DEFENSE OF USURY, SHEWING THE IMPolicy of the Present Legal Restraints on the Terms of Pecuniary Bargains in a Series of Letters to a Friend (1787).

25. In some cases dealing with the issue, the courts emphasize repeatedly that the issue has been raised and resolved many times, and seem to be frustrated with having to deal with it again. See, e.g., Yellowstone Capital LLC v. Central USA Wireless LLC, 2018 WL 3765121 (awarding attorney’s fees to the financier “in light of the history of these litigated matters and known binding precedent”).

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**EVADEING PROHIBITIONS ON USURY THROUGH CHOICE OF LAW**

William B. Emmal

Lenders frequently include a choice-of-law clause in their loan agreements. After all, a lender that operates in multiple states, or that lends to a borrower residing or conducting business in a state where the lender is not located, has a legitimate interest in knowing what law governs a particular loan transaction. Some lenders might also use such a choice-of-law clause to ensure that law more favorable to the lender applies. In particular, a lender might use a choice-of-law clause to avoid the usury law of the state whose law would apply if no choice were made.¹

However, the freedom to choose which state’s law governs a contractual relationship is not absolute. Parties are generally free to select what law governs their contract, provided, as § 187 of the Restatement (Second) of Conflict of Laws states: “(i) the chosen state has a substantial relationship to the parties or the transaction, or there is some other reasonable basis for the choice; and (ii) application of the law chosen does not violate fundamental policy of the state that has a materially greater interest in the issue and whose law would otherwise govern.”

The Restatement suggests that “fundamental policy” is a somewhat malleable concept, affected by such things as: (i) the difficulty in ascertaining which state’s law would apply in the absence of the choice, (ii) the amount of contacts the parties and the transaction have with the chosen state,² and the amount by which the interest rate exceeds the rate permitted by the law of the state that would otherwise govern.³ Nevertheless, the fact remains that states have different views on whether the protections against usury represent fundamental policy of the state, such that a contractual choice of another state’s law – one that permits higher interest rates or has no restriction on usury – will be disregarded.

Below is a chart summarizing which states treat their usury laws as establishing “fundamental policy,” so as to disregard a contractual selection of another state’s law (or, to put it another way, which states treat their laws against usury as reflecting a stronger policy than freedom of contract).

<table>
<thead>
<tr>
<th>Fundamental Policy</th>
<th>Not Fundamental Policy</th>
<th>Unclear or Follows a Different Approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pennsylvania⁴</td>
<td>Arkansas⁸</td>
<td>California¹⁶</td>
</tr>
<tr>
<td>South Dakota⁵</td>
<td>Florida⁹</td>
<td>Nebraska¹⁷</td>
</tr>
<tr>
<td>Washington⁶</td>
<td>Illinois¹⁰</td>
<td>Nevada¹⁸</td>
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<tr>
<td>West Virginia⁷</td>
<td>Kentucky¹¹</td>
<td>New Jersey¹⁹</td>
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<td></td>
<td>Massachusetts¹²</td>
<td>New York²⁰</td>
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<tr>
<td></td>
<td>Michigan¹³</td>
<td>Rhode Island²¹</td>
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</table>

**CONCLUSION**

A lender seeking to utilize a contractual choice-of-law provision to avoid the usury law of a state whose law might otherwise apply to the transaction should be wary. The tactic can be effective to avoid the usury law of some states, but not all, particularly if the contractual interest rate is substantially above what is permitted by the state whose law would otherwise apply. Other tactics, such as the use of a usury savings clause, are also effective only in some states.²² So, lenders need to carefully check the law of any state that might apply to a transaction.

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Notes:

1. Restatement (Second) of Conflict of Laws § 187 (1971). This article does not address the extent to which federal law preempts state restrictions on usury. See 12 U.S.C. § 85 (permitting national banks to charge the interest rate allowed by the laws of the state or territory where the bank is located); 12 U.S.C. § 1831d(1) (permitting federally insured, state-chartered banks to charge the rate allowed by the laws of the state or territory where the bank is located). This article also does not address the extent to which the choice-of-law rules in U.C.C. § 1-301(a) override or alter the conflict-of-laws analysis as expressed in the Restatement.

2. Restatement (Second) of Conflict of Laws § 187, at cmt. g.

3. Id. at § 203.

4. Gregoria v. Total Asset Recovery, Inc., 2015 WL 115501, at *4 (E.D. Pa. 2015); Kaneff v. Delaware Title Loans, Inc., 587 F.3d 616, 620-24 (3d Cir.2009) (so ruling in connection with a claim that the contract was unconscionable that the parties’ choice of law would violate Pennsylvania public policy). See also Pennsylvania Dep’t of Banking v. NCAS of Delaware, LLC, 948 A.2d 752, 759 n.9 (Pa. 2008) (parties’ contractual choice of law had no bearing on an action by the state Department of Banking for violating state law by charging fees that made the transaction usurious; suggesting in a footnote that the choice would not be enforceable anyway because it violates fundamental policy of the state).

5. State ex rel. Meierhenry v. Spiegel, Inc., 277 N.W.2d 298, 301 (S.D. 1979)).

6. O’Brien v. Shearson Hayden Stone, Inc., 586 P.2d 830, 833 (Wash. 1978). In a subsequent opinion in the case, the court suggested that if the contractual rate were only one or two percent higher than the maximum rate allowed under Washington law, the contractual choice of New York would have been permissible. See O’Brien v. Shearson Hayden Stone, Inc., 605 P.2d 779 (Wash. 1980).


11. Big Four Mills v. Commercial Credit Co., 211 S.W.2d 831, 836 (Ky. 1948).


14. Cf. Goodwin Bros. Leasing, Inc. v. H & B Inc., 597 S.W.2d 303, 307 (Tenn. 1980) (contracting parties may in good faith select as governing law the law of a state with a reasonable relationship to the parties or the transaction even if the transaction would be usurious under Tennessee law but not usurious under the chosen state’s law).


16. Palm Ridge, LLC v. Ahlers, 2008 WL 11339594, at *3 (C.D. Cal. 2008) (apparently establishing a range of interest rates in choice-of-law provisions that are permissible under California public policy despite recognizing a strong policy against usury). See also Sarlot-Kantarjian v. First Pa. Mortgage Trust, 599 F.2d 915, 918 (9th Cir. 1979) (a rate of 13.47% to 18% was not so far above the permitted rate of 10% to violate California’s policy against usury); Ury v. Jewelers Acceptance Corp., 38 Cal. Rptr. 376, 382-83 (1964) (parties’ choice of law establishing an interest rate of 20.3% was not so excessive as to violate California public policy); Gamer v. duPont Glore Forgan, Inc., 135 Cal. Rptr. 230, 234-35 (1976) (parties’ choice of law allowing New York interest rate of 12.25% was not so excessive as to violate public policy).

17. Exch. Bank & Tr. Co. v. Tamerius, 265 N.W.2d 847, 850 (Neb. 1978) (indicating that usury laws are “not so distinctive
a part of public policy” as to invalidate a contractual choice of law but ruling primarily that Texas law would have governed even absent its express selection in a promissory note because that was the place performance was due).

18. Ferdie Sievers & Lake Tahoe Land Co., Inc. v. Diversified Mortgage Investors, 603 P.2d 270, 273-74 (Nev. 1979) (upholding the parties’ choice of Massachusetts Law, which allowed a slightly higher interest rate, because Massachusetts was the state with the “dominant interest” in the transaction but also indicating that a choice of another state’s law should not be deemed to violate Nevada public policy unless “the rate is substantially above what our law allows as so to shock the conscience of the court.”).


20. Madden v. Midland Funding, LLC, 237 F. Supp. 3d 130, 150-51 (S.D.N.Y. 2017) (citing other cases ruling similarly). See also N. Am. Bank, Ltd. v. Schulman, 474 N.Y.S.2d 383, 386-87 (Ct. Ct. 1984) (the parties’ contractual choice of Israeli law, which has no prohibition on usury, would violate fundamental policy of New York but suggesting that selecting the law of a jurisdiction with only a slightly higher permissible interest rate would not violate fundamental policy of New York). But cf. A. Connor General Contracting, Inc. v. Rols Capital Co., 535 N.Y.S.2d 420, 421-22 (App. Div. 1988) (indicating that, in dealing with usury issues, New York courts apply the law of the state having the most significant contacts with the matter); Walter E. Heller & Co. v. Chopp-Wincraft Printing Specialties, Inc., 587 F. Supp. 557 (S.D.N.Y. 1982) (ruling that the chosen law – Illinois – would govern even absent the choice, but also suggesting that fundamental public policy of New York would not be offended by the choice because “the forum state chooses the state whose usury statute would sustain the contract in full or else impose the lightest penalty for usury from the set of all states that have a substantial relationship to the contract.”).


NON-UNIFORM UCC TEXT JEOPARDIZES ALL SECURED TRANSACTIONS GOVERNED BY MISSISSIPPI LAW

Stephen L. Sepinuck

Most, if not all, states varied the official text of the U.C.C. when enacting its various articles. Unfortunately, some of those involved lacked the commercial-law expertise or experience in legislative drafting needed to make the variation work as intended. Such appears to have been the case in Mississippi, where some non-uniform text added to § 9-623 poses a significant danger to secured transactions in that state.

The Mississippi version of § 9-623(b) provides in pertinent part as follows (red underlined text is additional, non-uniform language):

(b) To redeem collateral, a person shall tender:
   (1) Fulfillment of all obligations secured by the collateral then due or past due (excluding any sums that would not be due except for an acceleration provision); and . . .

The official text gives a debtor, a secondary obligor, and other lienholders a right to redeem the collateral by satisfying all the secured obligations. In all likelihood, the additional text was intended to give debtors a right to cure a default by paying the current and past-due portions of the secured obligation. But that is not what the text purports to do; the entire clause still refers to redeeming the collateral, not to curing the default. Applied as written, the non-uniform text allows the debtor to free the collateral from the secured obligation – i.e., discharge the security interest – by paying current and past-due charges.

But it is even worse than that. The non-uniform language dates back to Mississippi’s old Article 9, but at least that provision applied only “after default.” There is no such limiting language in either the uniform or Mississippi version of revised § 9-623(b). Accordingly, strict adherence to the text would permit a debtor in any Article 9 transaction governed by Mississippi law, immediately after the transaction was entered into when no amount was yet due, to redeem the collateral by paying nothing. In essence, the debtor has the unfettered right to convert a secured debt into an unsecured debt.

It is impossible to predict whether courts will follow the non-uniform text as written – and allow the debtor to redeem the collateral – or instead limit it to its likely intended meaning – by allowing the debtor to cure the default. Accordingly, until courts definitively answer that question or the legislature amends the provision, transactional lawyers need to be careful.
Fortunately, there is a partial solution to this problem. The debtor cannot waive the right to redeem prior to default, but parties to a secured transaction are free to select which state’s law governs their rights and duties, provided the chosen state bears a reasonable relation to the transaction. So, a Mississippi debtor and a lender located in another state and should be able, in the security agreement, to select the law of the lender’s state to govern such matters as redemption, even if the collateral is located in Mississippi. For a wholly intrastate transaction, in which both parties and the collateral are located in Mississippi, however, there is no easy solution.

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Notes:


2. See Black v. Peoples Bank and Trust Co., 437 So. 2d 26, 30 (Miss. 1983) (by adding the identical non-uniform text added to § 9-506 of old Article 9, “our legislature modified it to give the debtor an opportunity to mend the breach.”). See also Rankin Properties, Ltd. v. Woodhollow Estates, 714 F. Supp. 800, 802 & 803 n.7 (S.D. Miss. 1989) (referring to a debtor’s “attempt[] to cure” by invoking the non-uniform redemption right in old § 9-506 and stating that “Mississippi’s version of this section lessens the requirement of curing a default, allowing a debtor to tender only those amounts then due or past due.”). A right to cure is granted in another Mississippi statute, see Miss. Stat. § 89-1-59, but that statute has limited applicability. See Dungan v. Dick Moore, Inc., 463 So. 2d 1094, 1099 (Miss. 1985).

3. There is also some authority for the proposition that, to exercise this right, the debtor must also cure non-monetary defaults. See Bombardier Capital, Inc. v. Royer Homes of Mississippi, Inc., 2005 WL 8170128, S.D. Miss. 2005).


5. See Miss. Stat. §§ 75-9-602(11), 75-9-624(c) (each containing the official text). The right to redeem cannot be waived in a consumer-goods transaction even after default.


7. See U.C.C. § 1-301(a).

Recent Cases

SECURED TRANSACTIONS

Attachment Issues

In re Bates Drug Stores, Inc.,
A bank’s security interest in “[a]ll accounts, general intangibles, instruments, rents, monies, payments, and all other rights, arising out of a sale, lease, consignment or other disposition of any of the property described in this Collateral section” covered general intangibles only if they arose from the disposition of the described Collateral: inventory, accounts, and equipment. The bank’s security interest in “[a]ll records and data relating to any of the property described in this Collateral section” was similarly limited to records and data that relate to inventory, accounts, and equipment. Because the trial court made no determination of whether a receiver’s sale of “contracts, books and records, and intangibles,” related to inventory, accounts, or equipment, the case had to be remanded for a proper determination of whether the bank had a security interest in the proceeds.

In re Castillo,
2019 WL 2553610 (Bankr. N.D. Cal. 2019)
A debtor’s down payment made in connection with the purchase of a new car and the trade-in of a used car with negative equity was, pursuant to the terms of the contract, properly allocated toward reducing the negative equity. Because the financier’s security interest in the new car is not a PMSI to the extent of the negative equity, this increased the purchase-money nature of the security interest, thereby reducing the portion of the security interest that the debtor could treat as unsecured in his Chapter 13 bankruptcy. The court would not determine how payments on the loan should be allocated between the PMSI and non-PMSI portions because that issue was not properly raised or briefed.

In re Financial Oversight and Mgmt. Board for Puerto Rico,
2019 WL 2636270 (D.P.R. 2019)
Bondholders’ security interest in future employer contributions to an employee retirement system could not attach until the contingent factors affecting the amount of the contributions were fixed. Such factors included the size of the employer’s payroll and the number of former employee pensioners. The contributions were not proceeds of other collateral. Accordingly, the bondholders’ security interest in contributions made or due post-petition was cut off by § 552 of the Bankruptcy Code.
Perfection Issues

In re Wastetech, LLC,
A factor that filed a financing statement identifying the debtor as “NTC Waste Group, LLC,” approximately four months after the debtor had changed its name to “Wastetech, LLC,” did not have a perfected security interest because a search under the debtor’s correct name at the time the financing statement was filed would not have disclosed the financing statement. It did not matter that the factor was unaware of the name change or had begun its relationship with the debtor prior to the change in name. The financing statement’s collateral description – “[c]ertain future receivables . . . purchased by Crown Funding Group, Inc., . . . pursuant to that certain purchase and sale of future receivables agreement between seller and purchaser dated 8/7/2017” – was also inadequate to perfect because none of the agreements between the debtor and the factor bore that date and the factor was not Crown Funding Group.

Enforcement Issues

Hussein v. UBS Bank USA,
2019 WL 2376112 (Utah Ct. App. 2019)
Because the loan documents expressly gave the bank the right to accelerate the debt and liquidate the collateral – shares of stock in a corporation – whenever the bank deemed “its own or its security interest in the Collateral insecure,” the debtor had no cause of action against the bank for accelerating the debt and liquidating the collateral after the collateral had declined in value. It did not matter that the debtor had substantial assets because the clause dealt with whether the security interest had become insecure, not the insecurity of the loans.

People’s United Equipment Finance Corp v. TAK, LLC,
2019 WL 2744481 (E.D. La. 2019)
Because courts have discretion, under Louisiana law, to order sequestration of property without bond, and the parties’ security agreement expressly entitled the secured party to issuance of a writ of possession without the need to post a bond, a writ of seizure for the collateral – a wheel loader – would be issued without the secured party having to post a bond.

Wells Fargo Bank v. Suburu 46, LLC,
The clause in the credit agreement between a floor plan financier and several car dealerships, which provided for arbitration of “any claim or controversy arising out of or relating to the Loan Documents” other than “disputes under or related to swap agreements” and actions to foreclose, included the financier’s action on the debt. Even though computation of damages required using the rates and formula incorporated into the parties’ swap agreement, the swap agreement itself was not the subject of a dispute.

Even if the secured party conducted the disposition of collateral – equity interests in a subsidiary – in a commercially unreasonable manner, and even if the transferee did not act in good faith, the disposition transaction could not be unwound. Pursuant to § 9-617, the bad-faith transferee would take subject to the debtor’s rights, which at most would mean that the debtor could still exercise its right to redeem.

Bankruptcy Issues

Automatic Stay & Injunctions

In re Deemer,
A secured party that declined to repossess the inoperable car that the debtor had surrendered violated the discharge injunction by refusing to release the title certificate without payment because this prevented the debtor from disposing of the car.

Executory Contracts & Unexpired Leases

In re Woodfield,
The dissociation provision in an LLC operating agreement, which provided that upon filing a bankruptcy petition a member would no longer have the right to receive regular distributions but would instead be entitled to payment of the member’s capital-account balance over four years, was preempted by § 541(c)(1). Section 541(c)(1) also preempted the portion of the state LLC Act that provided for members to lose their membership status and voting rights upon filing for bankruptcy. However, even though the operating agreement was an executory contract, the debtor could not assign his interest without the consent of the other members, because state law made such consent necessary for any assignment to be effective, not merely for an assignment by a debtor in bankruptcy.

In re Orana Hospitality Group, Ltd.,
A landlord that had sold a liquor license to the debtor on credit and had an option to repurchase the license by setting off amounts due from the debtor, but which had not exercised the repurchase option petition, could not exercise the option postpetition for three reasons: (i) the landlord did not have a security interest in the liquor license because applicable state law does not permit one; (ii) the repurchase option was an executory contract that had been rejected; and (iii) the repurchase option, coupled with the right to pay by setting off the debtor’s obligation, was effectively an effort to create a prohibited security interest, and hence was unenforceable.
Avoidance Powers

_In re Wagenknecht_, 2019 WL 2353534 (10th Cir. BAP 2019), appeal filed (10th Cir. June 11, 2019)

A creditor that received payment during the preference period from the debtor’s mother, who in return received a promissory note from the debtor, did receive an interest of the debtor in property. Even though the mother signed an affidavit stating that she advanced the funds exclusively for the purpose of paying the creditor, and that the debtor could not have used the funds for any other purpose, the debtor had the ability to control the loan proceeds because he could have refused to accept a loan from his mother.


A debtor in possession, which was the surviving entity in a merger of limited liability companies that occurred the day before the bankruptcy petition was filed, cannot avoid as a preference a transfer deemed made when a secured party perfected the security interest granted by the non-surviving company. Even if the property transferred was property of the debtor, the property was not transferred on account of the antecedent debt of the debtor because the debtor could not have become liable for the debt until the merger occurred.

Lending, Contracting & Commercial Litigation

_In re Energy Future Holdings Corp._, 2019 WL 2535700 (3d Cir. 2019)

The holders of the highest tranche of first-lien debt – the whole of which was undersecured – were not entitled to post-petition interest out of the adequate protection payments and plan distributions allocated to the lower tranches because the waterfall in the intercreditor agreement dealt only with payments out of the proceeds of collateral or the exercise of remedies by the collateral agent. The payments were not made from property in which the creditors had a lien or from the exercise of remedies by the collateral agent.


Judgment debtors who entered into a forbearance agreement pursuant to which they granted the judgment creditor a mortgage on their home thereby lost the ability to claim the homestead exemption. Although the homestead exemption cannot normally be waived, the mortgage was more than a mere waiver of the exemption because it subordinated the judgment creditor to two other liens that were recorded after its judgment but before the mortgage and it secured additional fees and costs stemming from the forbearance.

_Spec’s Family Partners, Ltd. v. First Data Merchant Services LLC_, 2019 WL 2407306 (6th Cir. 2019)

A liquor retailer that was the victim of two attacks on its computer network was not liable to its data processor for the millions of dollars in fraudulent credit card charges that Visa and MasterCard passed on to the card issuers, which in turn passed them on to the data processor. Although the indemnification clause in the retailer’s contract with the data processor covered all losses and liability relating to any breach of the agreement, and the retailer had breached the agreement by failing to maintain data security, the clause also excluded liability for consequential damages, and the charges were consequential damages.


Because the communications between a prospective borrower and a potential lender expressly disclaimed any commitment to fund the borrower’s planned acquisition, and instead stated that the lender was merely agreeing to proceed with a review of the proposal, the borrower had no breach of contract claim against the lender for failing to fund the acquisition. However, the borrower did state claims for fraud and negligent misrepresentation by claiming that the lender had falsely indicated its ability to fund the acquisition.

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**Amicus Initiative Moves Forward**

*New Directors – First Partnership with Law Schools – First Brief*

The Commercial Law Amicus Initiative (“CLAI”) is delighted to make the following three announcements.

First, the following eight experts in commercial law have agreed to serve on CLAI’s Board of Directors:

- Teresa W. Harmon
- Juliet M. Moringiello
- Danielle K. Hart
- Sandra M. Rocks
- John F. Hilson
- Edwin E. Smith
- Christina Kunz
- Robert Zadek

The Board, now consists of these individuals plus the three founding directors – Stephen L. Sepinuck, Kristen D. Adams, and Jennifer S. Martin.

Second, students at both Gonzaga University School of Law and St Thomas University School of Law will be eligible to receive academic credit this fall for their work in furtherance of CLAI’s stated mission:

1. To assist the courts in faithfully interpreting and applying the Uniform Commercial Code, other commercial statutes, and related common law, in order to achieve the laws’ underlying policies and to facilitate consistent decision-making by the courts;

2. To advance education at law schools by providing law students with training and practical experience in pro bono advocacy relating to the proper application and interpretation of commercial law; and

3. To offer research and recommendations on matters of commercial law to non-profit organizations such as the American Law Institute and the Uniform Law Commission, in connection with such organizations’ preparation of uniform or model legislation or restatements of the law.

Finally, CLAI has completed and is awaiting permission to file its first *amicus curiae* brief. The brief, addressed to the Idaho Supreme Court, explains when a purchaser of goods acquires voidable title to the goods and when such a purchaser has the power to convey good title to a good faith purchaser for value. Anyone who wishes to receive a copy of the brief may request it by email to Professor Stephen L. Sepinuck at sepinuck@gonzaga.edu.

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