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SDNY Sustains RICO Claims Against Revenue-Based Financing Companies

July 30, 2022 | Katherine C. Fisher

In the last two months, the U.S. District Court for the Southern District of New York has issued three adverse decisions against revenue-based financing providers. In each case, the court sustained federal Racketeer Influenced and Corrupt Organizations Act ("RICO") claims against the funding companies or their principals. Each decision provides guidance on how to mitigate risk by updating contracts or adopting best practices. Providers of revenue-based financing must ensure that merchants can obtain reconciliations and that the daily or weekly payments disclosed in the contract represent a good-faith estimate of the merchant's future revenue. A summary of the most recent court decision, *Lateral Recovery LLC v. Queen Funding, LLC*, 2022 U.S. Dist. LEXIS 129032 (S.D. N.Y. July 20, 2022) appears below:

Case Summary

Lateral Recovery, LLC sued Queen Funding, LLC, Yehuda Klein and "John and Jane Doe Investors," claiming that they violated RICO by engaging in wire fraud and collecting unlawful debt. The defendants moved to dismiss the RICO claims, and the court denied the motion.

Queen Funding entered seven purchase of future receivables contracts (the "Contracts") with a merchant in 2017 and 2018. Each Contract required the merchant to pay a fixed amount every day, which the Contracts stated represented a "good-faith estimate" of 13% of the merchant's receivables. Over a two-year period, Queen Funding advanced approximately $6,500,000 in cash and collected about $10,500,000 in daily payments.

Wire Fraud Claim: Under RICO, "use of wire" includes email communication and wire transfers of money. The complaint alleged that Queen Funding and its owners used email to "originate, underwrite, service and collect upon" the Contracts. Queen Funding and its owners also allegedly collected amounts due under the Contracts through interstate electronic ACH debits.

The complaint alleged that the following false statements that appeared in all seven Contracts satisfied the fraud element of wire fraud:

- Alleged False Statement 1: The transaction is not a loan. The complaint alleged that the transactions were loans because, notwithstanding a "reconciliation provision," the Contracts required fixed daily payments, included a security interest in all the merchant's receivables and a personal guarantee of the individual owners, and Queen Funding relied on the creditworthiness of the merchant rather than the merchant's customers who owed the receivables.

- Alleged False Statement 2: The daily payment is a good faith estimate of the merchant's receivables. All seven Contracts stated that merchant's daily payment amount represented 13% of the merchant's anticipated monthly receivables. However, the daily payment amount ranged from $4,999 to $49,900.

- Alleged False Statement 3: The fixed daily payment is for the merchant's convenience. The complaint alleged that the fixed daily payment was to ensure that Queen Funding was paid and would not bear the risk of the creditworthiness of the purchased receivables.

- Alleged False Statement 4: The Contracts stated that Queen Funding's automated ACH program is "labor intensive" and is not an automated process, requiring the MCA company to charge an exorbitant "ACH Program Fee" or "Origination Fee." The complaint alleged that Queen Funding performed little or no due diligence, and the actual costs of the ACH withdrawals were a fraction of the fee.

Collecting an Unlawful Debt Claim: RICO defines "unlawful debt" as a debt that (1) is unenforceable in whole or in part because of usury with interest of at least twice the enforceable rate and (2) was incurred in connection with "the business of lending money."

The court explained that to determine whether a contract is a loan, courts examine whether the funder "is absolutely entitled to repayment under all circumstances" and whether the "principal sum advanced is repayable absolutely." The court examined the following four factors and concluded that the complaint sufficiently alleged that the Contracts were loans:

1. Reconciliation. The Contracts had a reconciliation provision to ensure that the merchant's daily payments represented 13% of the merchant's receipts. The court noted that "in theory" this suggested the Contracts were not loans because Queen Funding bears the risk of loss if receivables are not paid. However, the plaintiff alleged that the reconciliation provision was a "sham" because:
    - Queen Funding did not have a reconciliation department, did not perform reconciliations, and never refunded a merchant money as required under their reconciliation provision.

    - Queen Funding's obligation to provide a reconciliation was contingent on the merchant's providing documentation requested by Queen Funding "in its sole judgment" and in its "sole and absolute discretion." As a result, the court concluded that Queen Funding had the absolute ability to nullify any obligation to reconcile.

    - The Contracts described reconciliation as "a courtesy, and that [the funder] is under no obligation to provide same."

    - The Contracts stated that Queen Funding had no obligation to do a reconciliation "if the Merchant fails to furnish the requested documentation within five (5) business days following the end of a calendar month."

2. Indefinite Term. The Contracts stated that they had an indefinite term. However, the court found that a term could be easily calculated by dividing the amount the merchant owed by the amount of daily payments, and failure to make daily payments would not indefinitely extend the term

because the Contracts provided that a default would occur if two daily payments were not made during the term of the agreement and the merchant failed to contact Queen Funding in advance.

3. Recourse in the Event of Bankruptcy. The court concluded that a "Protections Against Default" section made payment due immediately and permitted seizure of the collateral in case of a default and the personal guaranty provision effectively shielded Queen Funding from the risk of loss if the merchant was nearly bankrupt or bankrupt.

4. Rejected ACHs as an Event of Default. Under the Contracts, an "Event of Default" occurs if "attempted ACH debit of the Specific Daily Amount is rejected two times during the term of [the Merchant Agreement] and the Merchant does not contact the funder in advance of the ACH debit being rejected." In such cases, payment became immediately due and Queen Funding was allowed to foreclose on the collateral, including any collateral held by the guarantor. For this reason as well, Queen Funding bore no "real transfer of risk," and therefore, "the economic substance of the transaction was a loan, not a purchase of receivables."

Lateral Recovery LLC v. Queen Funding, LLC, 2022 U.S. Dist. LEXIS 129032 (S.D. N.Y. July 20, 2022). The other two cases are *Haymount Urgent Care PC v GoFund Advance, LLC*, 2022 US Dist. LEXIS 112768 (S.D.N.Y. June 27, 2022) and *Fleetwood Servs., LLC v Ram Capital Funding, LLC*, 2022 US Dist. LEXIS 100837 (S.D.N.Y. June 6, 2022).

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