

Cash Advance Lenders In Small Biz Bankruptcy Crosshairs

By **Hilary Russ**

Law360 (July 9, 2024, 8:42 PM EDT) -- When Lynda Bui was tapped as the Chapter 7 trustee for a small bankrupt California lighting company called Vario Corp., she initially thought she would not recover any assets in the case, which involved a burdensome stack of ultra-high-interest merchant cash advances.



New York Attorney General Letitia James speaks at a news conference in February to address her office's action against Yellowstone Capital and other cash advance companies. James accused the lenders of exploiting and collecting billions of dollars from struggling small businesses through high-interest merchant cash advances. (AP Photo/Bebeto Matthews, File)

But she and Vario's bank teamed up to sue those lenders, recovering hundreds of thousands of dollars from them through settlements and ultimately paying creditors in full after professionals agreed to reduce their fees.

"I definitely think it's a success because not only did we recover a decent percentage, but also we paid creditors 100%," Bui said, even though the estate had no operating income or any cash infusion from principals.

Her case, along with others including that of **Jambys Inc.** and Blue Jay Communications, show how debtors and trustees have been fighting the lenders behind such arrangements for merchant cash advance, or MCA, casting them as usurious short-term loans plaguing small businesses that are desperate

for a lifeline.

"I call them ... payday lending for business," said solo practitioner Frederic P. Schwieg, who represented Blue Jay in its 2021 Subchapter V bankruptcy in the Northern District of Ohio. A couple of Blue Jay's MCA lenders charged what amounts to more than 800% annualized interest, according to objections to the lenders' claims.

"In almost every small business I'm working with, they've at least tried it once. You're just constantly running into them," Schwieg said of MCA agreements. "It is more and more common that when you see one, you see more of them."

MCA lenders are now drawing the attention of the U.S. Securities and Exchange Commission for their money-raising practices and various state attorneys general for their usurious rates. However, several lenders in this sector operate lawfully, according to Joe Luzinski, a senior managing director at turnaround consultant Development Specialists Inc. who has served as a chief restructuring officer for a bankrupt MCA firm.

"It is a legitimate industry with lots of very specific rules and regulations that has a lot of illegitimate people working in it and a lot of fringe people working at the back end (in collections)," Luzinski said.

While many MCA lenders appear similar to a bank, with structures and systems in place, "the reality is if you can fog a mirror, and you're willing to sign a guarantee, and you're not on the FBI's most wanted list, you're probably going to be eligible to get a merchant cash advance," he elaborated.

Once a business gets an MCA, it usually gets another — despite provisions stipulating that a borrower will not stack up multiple advances — and it's very hard to get out of the loop, especially when the lender starts offering to roll existing agreements into new ones, Luzinski said.

"At some point, these deals are just not sustainable, and a lot of these small businesses crash and burn," he said.

MCA Under Fire

An Ohio microfactory operator called Haney Inc. filed for Chapter 11 protection June 21, 2024, just as a key provision to qualify for Subchapter V was **getting ready to expire**. On its balance sheet, Haney listed the usual loans and credit card debt, as well as 16 separate MCAs.

Eric Goering of Goering & Goering LLC, counsel for Haney, said, "A lot of the MCAs don't give you an address, don't give you a phone number and don't give you an email."

In March, New York Attorney General Letitia James **sued more than 30 companies** and individuals for at least \$1.4 billion, alleging they made up a predatory MCA lending operation that exploited small businesses.

The operation, she said, is linked to businessman David Glass, whose account of working at notorious Long Island investment firm Sterling Foster & Co. in the 1990s later inspired the movie "Boiler Room." In 2008, Glass was banned from the securities industry after pleading guilty to insider trading at a firm he founded.

James' lawsuit came a month after her office won a \$77.3 million judgment against three MCA providers, among her efforts to target and shut down companies that she said actually provide illegal short-term loans well over New York's criminal usury rate of 25%.

MCA companies usually operate by claiming they will buy a portion of a merchant's future sales revenue at a discount in exchange for a quick lump sum of cash. They then withdraw fixed amounts from the business's bank accounts daily or weekly. Often, the company's founder or other officers personally guarantee the agreements.

At least three entities being prosecuted by James' office — Cloudfund LLC, Delta Bridge Funding LLC and Velocity Capital Group LLC, which the attorney general said are new aliases for units of Glass' supposedly wound down Yellowstone Capital LLC — are also named in Jambys' adversary suit. That case was amended June 4 this year to add new defendants and a demand for triple damages under a racketeering allegation.

Contact information for Cloudfund and Delta Bridge could not be located. Velocity did not respond to a request for comment.

MCA lenders can sometimes get aggressive with a bankrupt business. A couple of weeks after solar energy firm iSun Inc. filed for Chapter 11 protection **last month**, it was slapped with an adversary complaint by Cedar Advance LLC over its cash advance agreement that had called, prepetition, for Cedar to have "unfettered access" to an iSun account, from which the lender would withdraw 5% of iSun's receivables weekly.

Cedar also argued that iSun's collateral — the accounts receivable — does not belong to it, and therefore it shouldn't be allowed to use it in bankruptcy.

Use of collateral was also contested by two MCA lenders in Jambys' Chapter 11. They contended that Jambys should not be allowed to use about \$136,000 worth of goods, mostly stored in U.S. Amazon fulfillment centers, to run the business, saying the collateral belonged to them and not the debtor's estate.

A Delaware bankruptcy judge allowed Jambys to use the collateral during a July 3 hearing after the company agreed to reserve the MCA lenders' rights.

Avoiding Judgment

But MCA lenders are only willing to push the line so far in a bankruptcy case, according to Luzinski.

"They don't like bankruptcy because if they get a bad ruling in one bankruptcy case, it could be a pox on the entire industry," he explained.

"You see very, very few of them that will take their claims and litigate to the mat because that bad ruling is something they want to avoid," Luzinski said. "They may fight a little bit, but they're going to work very hard to never take a trial and have an adverse judgment."

In Vario's case, Bui filed complaints against multiple MCA lenders with about 20 different causes of action — including fraudulent transfer and preference — and ultimately won settlements with all of them, recovering as much as 70% from one.

"What helped us was most of these MCAs filed claims in the bankruptcy, so they subjected themselves to the jurisdiction of the bankruptcy court," Bui said. "We got to see them here without having to chase them throughout the country."

Sometimes, however, a case goes sideways.

John F. Houlihan started the small Cleveland-based telecommunications company Blue Jay in 2002 with four other employees and two trucks out of his home garage, according to the Subchapter V reorganization plan he filed in February 2022.

With the onset of the COVID-19 pandemic, Blue Jay's customers began delaying installation work, and the company's annual gross revenue plunged to \$11.4 million in 2020. When business picked back up in early 2021, Blue Jay suddenly needed cash.

The company had already maxed out its ability to borrow from Huntington National Bank, so it turned to MCA lenders. From May through October 2021, Blue Jay received more than \$2.5 million via 10 different MCA agreements with various firms in exchange for future receipts.

But the advances put a strain on Blue Jay's cash. When some MCA lenders tried to seize Blue Jay's accounts receivable, the company filed for bankruptcy.

Yet, after Blue Jay's reorganization plan was confirmed, Houlihan went to three new MCA lenders, getting a total of \$572,000. The agreements caused the company to overdraw its Huntington bank accounts, and it pledged collateral in violation of its bank loans, Huntington said in court filings.

As a result, the court stripped Houlihan's control of the company, handing it to a Subchapter V trustee in February 2023 and pausing the adversary case in May 2024.

"Business people are incurably optimistic. You have to be, or you'd never go into business," Schwieg, the debtor's attorney, said. "They're thinking, 'If I just borrow this money, it'll turn around.' They're looking at an extremely short-term thing."

--Editing by Covey Son.

All Content © 2003-2024, Portfolio Media, Inc.