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SECURED TRANSACTIONS

‘Shoot the Moon’: True Sales Versus Secured Loans

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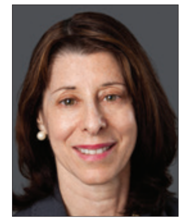

Practitioners may have a tendency to think of Uniform Commercial Code Article 9 as applicable just to secured financings. But as many of us are often reminded, Article 9 also governs sales of certain assets. UCC §9-109 details the different types of transactions that are subject to the purview of UCC Article 9. Among those are sales of accounts, chattel paper, payment intangibles and promissory notes.

Although sales and secured loans are both subject to UCC Article 9, it can be difficult at times to tell which is which. This is a distinction with a difference, however, because, unlike assets pledged as collateral, assets that are sold will not be included in a bankrupt debtor’s estate. As such, after a bankruptcy petition is filed, a creditor in a secured loan transaction will be subject to the automatic stay and its claim on the underlying assets may be junior to those of other creditors. A buyer in a true sale, on the other hand, is not subject to these bankruptcy risks because it owns the assets outright.

UCC Article 9 does not explain how to differentiate a true sale from a secured loan. Instead, the commentary to UCC §9-109 notes that “[i]n many commercial financing transactions, the distinction is blurred,” and then warns that the statute does not “delineate how a particular transaction is to be classified” and accordingly this “issue is left to the courts.” Interestingly, Article 9 itself uses the terminology of “debtor” and “secured party” without regard to whether the relevant transaction is a sale or a secured financing.

This issue was at the forefront of a recent decision by a Montana bankruptcy court, *Cap Call v. Foster (In re Shoot the Moon)*, 2021 WL 4144933 (Bankr. D. Mont. Sept. 10, 2021), involving a challenge to 18 separate transactions that were in the form of sales of receivables, but which the bankruptcy trustee asserted were instead disguised loans. U.S. Bankruptcy Judge Whitman L. Holt agreed with the bankruptcy trustee. In so doing, the judge held that simply calling a transaction a true sale does not make it so. Rather, in a detailed and heavily footnoted discussion, the judge ruled that a holistic set of factors should be considered in making that determination.

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Background

Shoot the Moon was a restaurant business formed in the early 2000s that by 2015 had grown to more than 16 locations throughout Idaho, Montana and Washington. Over time, however, Shoot the Moon encountered financial difficulties that prompted it to obtain additional financing from various

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sources. One of these sources was CapCall, a merchant cash advance company. Between October 2014 and September 2015, Shoot the Moon and CapCall entered into 18 separate transactions, in each case based on CapCall's standard form documentation. Through these transactions, CapCall agreed to provide Shoot the Moon with immediate funds in exchange for acquiring receivables that Shoot the Moon generated from its restaurant operations. On Oct. 21, 2015, Shoot the Moon filed for Chapter 11 bankruptcy in the United States Bankruptcy Court for the District of Montana. After the petition date, Shoot the Moon's credit card processing company held $228,449.93 worth of credit card payments that the restaurant operations generated pre-petition. This balance was ultimately transferred to a segregated account, pending resolution of disputes between CapCall and Shoot the Moon.

The 'Shoot the Moon' Case

In August 2017, CapCall filed a complaint against the bankruptcy trustee for Shoot the Moon, seeking monetary damages for conversion and a declaratory judgment that the remaining balance of funds in the segregated account belonged to CapCall. It argued, among other things, that the 18 transactions were true sales and, accordingly, that CapCall was entitled to the entire amount of receivables in the segregated account. In response, CapCall pointed to provisions in the underlying agreements stating that the transactions were to be treated as true sales, rather than loans. The bankruptcy trustee counterclaimed, arguing that the 18 transactions were actually secured loans disguised as true sales.

The threshold question of choice of law was particularly important here, given Montana had a more stringent usury law than New York (interest was capped at 15% by any lender (other than a regulated lender)). Quoting the court, "Since New York lacks a usury statute analogous to Montana's, adopting the law of either state has drastic implications on the outcome of the Trustee's claim." The CapCall agreements stated they were governed by New York law. However, the court viewed the jurisdictions as aligned in their approach to analyzing the transactions under state law—namely, that a transaction must be judged by its substance and not form. The court then simply skipped past the choice of law question, at least as to the issue of sale versus loan.

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The court went on to explain that, in order to distinguish a true sale from a secured loan, a given transaction should be analyzed on the basis of a "fact-intensive" examination of the "totality of the circumstances." Factors to be considered included whether the purported buyer has a right of recourse against the seller, the language of the underlying agreements, the conduct of the parties, and whether the buyer can unilaterally alter the pricing terms. A common link among the relevant factors is how the parties allocate risk. In a true sale, the risk of loss from the underlying assets is largely on the buyer. In a secured loan, that risk is often shared by both parties.

In the case at hand, the court concluded that the transaction was actually a disguised loan, and it found three factors to be particularly persuasive. The first was that the security interests granted by each of the underlying agreements were very broad—in the court's view, a characteristic more indicative of a secured loan than a true sale. For example, one of the underlying agreements granted CapCall a security interest in all of Shoot the Moon's "payment and general intangibles … goods; inventory; equipment and fixtures … and all proceeds of the foregoing." In Judge Holt's view, in a true sale there would be no reason for CapCall to have any security interests [apart from the future receivables that it purchased]. This reduced CapCall's risk with respect to the future receivables, a feature more commonly seen in loan transactions.

Next, the court noted that the underlying agreements gave CapCall a broad "panoply" of rights and remedies in addition to recourse against property of Shoot the Moon, including a personal guaranty and confession of judgment from its principal. This further reduced CapCall's risk in the transaction, and, in the court's view, was yet another feature more typical of secured loans rather than true sales. CapCall argued that these rights and recourse provisions were irrelevant because CapCall never actually utilized them, but the court was quick to dismiss this argument, stating that CapCall could not "simply disclaim those features to reframe the transactions as sales."

Lastly, the court examined CapCall and Shoot the Moon's previous communications and found that the parties referred to the transactions as "loans" with "terms" and "balances." In addition, most of the UCC-1 financing statements that were filed pursuant to the transactions referred to each Shoot the Moon entity as a "debtor," rather than a "seller."

The court dismissed reliance on CapCall's argument that the agreements themselves described the transaction as a sale, explaining that a "conclusory" label such as this cannot change the true character of a transaction. The court acknowledged, though, that there were legitimate factors pointing in the other direction, including that none of the underlying agreements specified a fixed term and they included reconciliation provisions (meaning Shoot the Moon could seek an adjustment of the amounts being taken out of its account based on its cash flow (or lack thereof)). Still, the court concluded that it would be a "rare case … when every factor points in the same direction," and other factors weighed in favor of these transactions being loans under state law.

Discussion

It's hard to disagree with the court's emphasis on substance over form. Many of the important factors noted in its opinion are indeed red flags for a party seeking sale treatment under commercial law. Some of those are clearly questionable, however. For example, the court's negative view on use of the word "debtor" to describe Shoot the Moon in both UCC financing statement forms and elsewhere is misplaced. As noted above, UCC commentary confirms that the terms "debtor" and "secured party" refer to the principal counterparties for all transactions covered by Article 9, whether sales or secured financings.

In re Shoot the Moon demonstrates the holistic, fact-driven analysis that courts may undertake in order to distinguish true sales from collateralized obligations. Explicit provisions characterizing the intent of the parties in regard to sale or financing treatment remain critical, and the court did cite that as one of the important factors. But it was also clear that this would not, in and of itself, be sufficient to determine a characterization. *In re Shoot the Moon* provides a helpful insight to the other types of factors that a court might consider in its analysis.

Moving forward, buyers should exercise great care to ensure that their transaction documentation and communications are truly indicative of a true sale, rather than a secured loan, so as to mitigate potential bankruptcy risks. The bankruptcy court decision in *Shoot the Moon* has been appealed. It will be interesting to see if the District Court has a different view.