CALIFORNIA BANKRUPTCY FORUM

Squeezing the Grapes:
Untangling Merchant Cash Advances in Bankruptcy

May 15, 2026

Speakers:

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United States Bankruptcy Court for the Northern District of California

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Unif.Commercial Code § 9-406

§ 9-406. Discharge of Account Debtor; Notification of Assignment; Identification and Proof of Assignment; Restrictions on Assignment of Accounts, Chattel Paper, Payment Intangibles, and Promissory Notes Ineffective.

Currentness

(a) **[Discharge of account debtor; effect of notification.]** Subject to subsections (b) through (i) and (l), an account debtor on an account, chattel paper, or a payment intangible may discharge its obligation by paying the assignor until, but not after, the account debtor receives a notification, ~~**authenticated**~~ signed by the assignor or the assignee, that the amount due or to become due has been assigned and that payment is to be made to the assignee. After receipt of the notification, the account debtor may discharge its obligation by paying the assignee and may not discharge the obligation by paying the assignor.

(b) **[When notification ineffective.]** Subject to ~~**subsection**~~ subsections (h) and (l), notification is ineffective under subsection (a):

(1) if it does not reasonably identify the rights assigned;

(2) to the extent that an agreement between an account debtor and a seller of a payment intangible limits the account debtor's duty to pay a person other than the seller and the limitation is effective under law other than this article; or

(3) at the option of an account debtor, if the notification notifies the account debtor to make less than the full amount of any installment or other periodic payment to the assignee, even if:

(A) only a portion of the account, chattel paper, or payment intangible has been assigned to that assignee;

(B) a portion has been assigned to another assignee; or

(C) the account debtor knows that the assignment to that assignee is limited.

(c) **[Proof of assignment.]** Subject to ~~**subsection**~~ subsections (h) and (l), if requested by the account debtor, an assignee shall seasonably furnish reasonable proof that the assignment has been made. Unless the assignee complies, the account debtor may discharge its obligation by paying the assignor, even if the account debtor has received a notification under subsection (a).

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(d) [**Term restricting assignment generally ineffective.]** In this subsection, "promissory note" includes a negotiable instrument that evidences chattel paper. Except as otherwise provided in subsections (e) and (k) and Sections 2A-303 and 9-407, and subject to subsection (h), a term in an agreement between an account debtor and an assignor or in a promissory note is ineffective to the extent that it:

(1) prohibits, restricts, or requires the consent of the account debtor or person obligated on the promissory note to the assignment or transfer of, or the creation, attachment, perfection, or enforcement of a security interest in, the account, chattel paper, payment intangible, or promissory note; or

(2) provides that the assignment or transfer or the creation, attachment, perfection, or enforcement of the security interest may give rise to a default, breach, right of recoupment, claim, defense, termination, right of termination, or remedy under the account, chattel paper, payment intangible, or promissory note.

(e) **[Inapplicability of subsection (d) to certain sales.]** Subsection (d) does not apply to the sale of a payment intangible or promissory note, other than a sale pursuant to a disposition under Section 9-610 or an acceptance of collateral under Section 9-620.

(f) **[Legal restrictions on assignment generally ineffective.]** Except as otherwise provided in subsection (k) and Sections 2A-303 and 9-407 and subject to subsections (h) and (i), a rule of law, statute, or regulation that prohibits, restricts, or requires the consent of a government, governmental body or official, or account debtor to the assignment or transfer of, or creation of a security interest in, an account or chattel paper is ineffective to the extent that the rule of law, statute, or regulation:

(1) prohibits, restricts, or requires the consent of the government, governmental body or official, or account debtor to the assignment or transfer of, or the creation, attachment, perfection, or enforcement of a security interest in the account or chattel paper; or

(2) provides that the assignment or transfer or the creation, attachment, perfection, or enforcement of the security interest may give rise to a default, breach, right of recoupment, claim, defense, termination, right of termination, or remedy under the account or chattel paper.

(g) **[Subsection (b)(3) not waivable.]** Subject to ~~**subsection**~~ subsections (h) and (l), an account debtor may not waive or vary its option under subsection (b)(3).

(h) **[Rule for individual under other law.]** This section is subject to law other than this article which establishes a different rule for an account debtor who is an individual and who incurred the obligation primarily for personal, family, or household purposes.

(i) **[Inapplicability to health-care-insurance receivable.]** This section does not apply to an assignment of a health-care-insurance receivable.

(j) **[Section prevails over specified inconsistent law.]** This section prevails over any inconsistent provisions of the following statutes, rules, and regulations:

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[List here any statutes, rules, and regulations containing provisions inconsistent with this section.]

(k) **[Inapplicability to interests in certain entities.]** Subsections (d), (f), and (j) do not apply to a security interest in an ownership interest in a general partnership, limited partnership, or limited liability company.

(l) **[Inapplicability of certain subsections.]** Subsections (a), (b), (c), and (g) do not apply to a controllable account or controllable payment intangible.

Legislative Note: States that amend statutes, rules, and regulations to remove provisions inconsistent with this section need not enact subsection (j)

In 2018, a new subsection (k) was added to Section 9-406. A state that has not previously enacted that subsection should consider doing so in connection with the enactment of the 2022 Amendments.

Editors' Notes

OFFICIAL COMMENT

1. **Source.** Former Section 9-318(3), (4).

2. **Account Debtor's Right to Pay Assignor Until Notification.** Subsection (a) provides the general rule concerning an account debtor's right to pay the assignor until the account debtor receives appropriate notification. The revision makes clear that once the account debtor receives the notification, the account debtor cannot discharge its obligation by paying the assignor. It also makes explicit that payment to the assignor before notification, or payment to the assignee after notification, discharges the obligation. No change in meaning from ~~former~~ pre-1998 Section 9-318 is intended. Nothing in this section conditions the effectiveness of a notification on the identity of the person who gives it. An account debtor that doubts whether the right to payment has been assigned may avail itself of the procedures in subsection (c). See Comment 4. As to the rights and powers of an assignee generally, see Section 9-102(a)(7A) (defining "assignee"), (7B) (defining "assignor"), and Comment 2.b.1.

An effective notification under subsection (a) must be ~~authenticated~~ signed. This requirement normally could be satisfied by sending notification on the notifying person's letterhead or on a form on which the notifying person's name appears. In each case the printed name would be a symbol adopted by the notifying person for the purpose of identifying the person and adopting the notification. See Section ~~9-102~~ 1-201(b)(37) (defining ~~"authenticate"~~ "sign").

Subsection (a) applies only to account debtors on accounts, chattel paper, and payment intangibles. (Section 9-102 defines the term "account debtor" more broadly, to include those obligated on all general intangibles.) Although subsection (a) is more precise than its predecessor, it probably does not change the rule that applied under former Article 9. Former Section 9-318(3) referred to the account debtor's obligation to "pay," indicating that the subsection was limited to account debtors on accounts, chattel paper, and other payment obligations.

3. **Limitations on Effectiveness of Notification.** Subsection (b) contains some special rules concerning the effectiveness of a notification under subsection (a).

Subsection (b)(1) tracks former Section 9-318(3) by making ineffective a notification that does not reasonably identify the rights assigned. A reasonable identification need not identify the right to payment with specificity, but what is reasonable also is not left to the arbitrary decision of the account debtor. If an account debtor has doubt as to the adequacy of a notification, it may

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not be safe in disregarding the notification unless it notifies the assignee with reasonable promptness as to the respects in which the account debtor considers the notification defective.

Subsection (b)(2), which is new, applies only to sales of payment intangibles. It makes a notification ineffective to the extent that other law gives effect to an agreement between an account debtor and a seller of a payment intangible that limits the account debtor's duty to pay a person other than the seller. Payment intangibles are substantially less fungible than accounts and chattel paper. In some (e.g., commercial bank loans), account debtors customarily and legitimately expect that they will not be required to pay any person other than the financial institution that has advanced funds.

It has become common in financing transactions to assign interests in a single obligation to more than one assignee. Requiring an account debtor that owes a single obligation to make multiple payments to multiple assignees would be unnecessarily burdensome. Thus, under subsection (b)(3), an account debtor that is notified to pay an assignee less than the full amount of any installment or other periodic payment has the option to treat the notification as ineffective, ignore the notice, and discharge the assigned obligation by paying the assignor. Some account debtors may not realize that the law affords them the right to ignore certain notices of assignment with impunity. By making the notification ineffective at the account debtor's option, subsection (b)(3) permits an account debtor to pay the assignee in accordance with the notice and thereby to satisfy its obligation *pro tanto*. Under subsection (g), the rights and duties created by subsection (b)(3) cannot be waived or varied.

4. **Proof of Assignment.** Subsection (c) links payment with discharge, as in subsection (a). It follows former Section 9-318(3) in referring to the right of the account debtor to pay the assignor if the requested proof of assignment is not seasonably forthcoming. Even if the proof is not forthcoming, the notification of assignment would remain effective, so that, in the absence of reasonable proof of the assignment, the account debtor could discharge the obligation by paying either the assignee or the assignor. Of course, if the assignee did not in fact receive an assignment, the account debtor cannot discharge its obligation by paying a putative assignee who is a stranger. The observations in Comment 3 concerning the reasonableness of an identification of a right to payment also apply here. An account debtor that questions the adequacy of proof submitted by an assignee would be well advised to promptly inform the assignee of the defects.

An account debtor may face another problem if its obligation becomes due while the account debtor is awaiting reasonable proof of the assignment that it has requested from the assignee. This section does not excuse the account debtor from timely compliance with its obligations. Consequently, an account debtor that has received a notification of assignment and who has requested reasonable proof of the assignment may discharge its obligation by paying the assignor at the time (or even earlier if reasonably necessary to avoid risk of default) when a payment is due, even if the account debtor has not yet received a response to its request for proof. On the other hand, after requesting reasonable proof of the assignment, an account debtor may not discharge its obligation by paying the assignor substantially in advance of the time that the payment is due unless the assignee has failed to provide the proof seasonably.

5. **Contractual Restrictions on Assignment.** ~~Former~~ Pre-1998 Section 9-318(4) rendered ineffective an agreement between an account debtor and an assignor which prohibited assignment of an account (whether outright or to secure an obligation) or prohibited a security assignment of a general intangible for the payment of money due or to become due. Subsection (d) essentially follows ~~former~~ pre-1998 Section 9-318(4), but expands the rule of free assignability to chattel paper (subject to Sections 2A-303 and 9-407) and promissory notes and explicitly overrides both restrictions and prohibitions of assignment. The policies underlying the ineffectiveness of contractual restrictions under this section build on common-law developments that essentially have eliminated legal restrictions on assignments of rights to payment as security and other assignments of rights to payment such as accounts and chattel paper. Any that might linger for accounts and chattel paper are addressed by ~~new~~ subsection (f). See Comment 6.

The first sentence of subsection (d) ensures that the subsection applies to a negotiable instrument that would be a promissory note but for (i) the exclusion of writings that evidence chattel paper from the definition of "instrument" (Section 9-102(a)(47), as revised in 2022) and (ii) the definition of "promissory note" (Section 9-102(a)(65)) as a subset of "instrument." That sentence

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also ensures that subsection (d) applies to an obligor on such a negotiable instrument, even though the obligor is not an "account debtor" (Section 9-102(a)(3)). The sentence restores the scope of subsection (d) to apply to all obligations and obligors on chattel paper, as was the case prior to the revision of the definition of "instrument".

Former Section 9-318(4) did not apply to a sale of a payment intangible (as described in the former provision, "a general intangible for money due or to become due") but did apply to an assignment of a payment intangible for security. Subsection (e) continues this approach and also makes subsection (d) inapplicable to sales of promissory notes. Section 9-408 addresses anti-assignment clauses with respect to sales of payment intangibles and promissory notes.

Like former Section 9-318(4), subsection (d) provides that anti-assignment clauses are "ineffective." The quoted term means that the clause is of no effect whatsoever; the clause does not prevent the assignment from taking effect between the parties and the prohibited assignment does not constitute a default under the agreement between the account debtor and assignor. However, subsection (d) does not override terms that do not directly prohibit, restrict, or require consent to an assignment but which might, nonetheless, present a practical impairment of the assignment. Properly read, however, subsection (d) reaches only covenants that prohibit, restrict, or require consents to assignments; it does not override all terms that might "impair" an assignment in fact.

Example: Buyer enters into an agreement with Seller to buy equipment that Seller is to manufacture according to Buyer's specifications. Buyer agrees to make a series of prepayments during the construction process. In return, Seller agrees to set aside the prepaid funds in a special account and to use the funds solely for the manufacture of the designated equipment. Seller also agrees that it will not assign any of its rights under the sale agreement with Buyer. Nevertheless, Seller grants to Secured Party a security interest in its accounts. Seller's anti-assignment agreement is ineffective under subsection (d); its agreement concerning the use of prepaid funds, which is not a restriction or prohibition on assignment, is not. However, if Secured Party notifies Buyer to make all future payments directly to Secured Party, Buyer will be obliged to do so under subsection (a) if it wishes the payments to discharge its obligation. Unless Secured Party releases the funds to Seller so that Seller can comply with its use-of-funds covenant, Seller will be in breach of that covenant.

In the example, there appears to be a plausible business purpose for the use-of-funds covenant. However, a court may conclude that a covenant with no business purpose other than imposing an impediment to an assignment actually is a direct restriction that is rendered ineffective by subsection (d).

6. **Legal Restrictions on Assignment.** Former Section 9-318(4), like subsection (d) of this section, addressed only contractual restrictions on assignment. The former section was grounded on the reality that legal, as opposed to contractual, restrictions on assignments of rights to payment had largely disappeared. New subsection (f) codifies this principle of free assignability for accounts and chattel paper. For the most part the discussion of contractual restrictions in Comment 5 applies as well to legal restrictions rendered ineffective under subsection (f).

7. **Multiple Assignments.** This section, like former Section 9-318, is not a complete codification of the law of assignments of rights to payment. In particular, it is silent concerning many of the ramifications for an account debtor in cases of multiple assignments of the same right. For example, an assignor might assign the same receivable to multiple assignees (which assignments could be either inadvertent or wrongful). Or, the assignor could assign the receivable to assignee-1, which then might re-assign it to assignee-2, and so forth. The rights and duties of an account debtor in the face of multiple assignments and in other circumstances not resolved in the statutory text are left to the common-law rules. See, e.g., Restatement (2d), Contracts §§ 338(3), 339. The failure of former Article 9 to codify these rules does not appear to have caused problems.

8. **Consumer Account Debtors.** Subsection (h) is new. It makes clear that the rules of this section are subject to other law establishing special rules for consumer account debtors.

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9. **Account Debtors on Health-Care-Insurance Receivables.** Subsection (i) also is new. The obligation of an insurer with respect to a health-care-insurance receivable is governed by other law. Section 9-408 addresses contractual and legal restrictions on the assignment of a health-care-insurance receivable.

10. **Inapplicability to Certain Ownership Interests.** ~~This section does~~ Subsection (k) provides that subsections (d), (f), and (j) do not apply to a security interest in an ownership interest in a limited liability company, limited partnership, or general partnership, regardless of the name of the interest and whether the interest: (i) pertains to economic rights, governance rights, or both; (ii) arises under: (a) an operating agreement, the applicable limited liability company act, or both; or (b) a partnership agreement, the applicable partnership act, or both; or (iii) is owned by: (a) a member of a company or transferee or assignee of a member; or (b) a partner or a transferee or assignee of a partner; or (iv) comprises contractual, property, other rights, or some combination thereof. Ownership interests referred to in subsection (k) include interests in a series of a limited liability company, limited partnership, or general partnership, if the series is a "person" (Section 1-201(b)(27)).

11. **Controllable Accounts and Controllable payment intangibles.** For controllable accounts and controllable payment intangibles, subsection (l) recognizes that subsections (a), (b), (c) and (g) are replaced by analogous provisions in Section 12-106.

12. **"Signed" Replaces "Authenticated."** Consistent with the revised definition of "sign" in Section 1-201, the cognate term "signed" replaces the reference to "authenticated" in the pre-2022 text of this section.

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Unif. Commercial Code § 9-406, ULA UCC § 9-406

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Unif.Commercial Code § 9-318

§ 9-318. No Interest Retained in Right to Payment that is Sold; Rights and Title of Seller of Account or Chattel Paper with Respect to Creditors and Purchasers.

Currentness

(a) **[Seller retains no interest.]** A debtor that has sold an account, chattel paper, payment intangible, or promissory note does not retain a legal or equitable interest in the collateral sold.

(b) **[Deemed rights of debtor if buyer's security interest unperfected.]** For purposes of determining the rights of creditors of, and purchasers for value of an account or chattel paper from, a debtor that has sold an account or chattel paper, while the buyer's security interest is unperfected, the debtor is deemed to have rights and title to the account or chattel paper identical to those the debtor sold.

Editors' Notes

OFFICIAL COMMENT

1. **Source.** New.

2. **Sellers of Accounts, Chattel Paper, Payment Intangibles, and Promissory Notes.** Section 1-201(b)(35) defines "security interest" to include the interest of a buyer of accounts, chattel paper, payment intangibles, or promissory notes. See also Section 9-109(a) and Comment 5. Subsection (a) makes explicit what was implicit, but perfectly obvious, under former Article 9: The fact that a sale of an account or chattel paper gives rise to a "security interest" does not imply that the seller retains an interest in the property that has been sold. To the contrary, a seller of an account or chattel paper retains no interest whatsoever in the property to the extent that it has been sold. Subsection (a) also applies to sales of payment intangibles and promissory notes, transactions that were not covered by former Article 9. Neither this Article nor the definition of "security interest" in Section 1-201 provides rules for distinguishing sales transactions from those that create a security interest securing an obligation.

3. **Buyers of Accounts and Chattel Paper.** Another aspect of sales of accounts and chattel paper also was implicit, and equally obvious, under former Article 9: If the buyer's security interest is unperfected, then for purposes of determining the rights of certain third parties, the seller (debtor) is deemed to have all rights and title that the seller sold. The seller is deemed to have these rights even though, as between the parties, it has sold all its rights to the buyer. Subsection (b) makes this explicit. As a consequence of subsection (b), if the buyer's security interest is unperfected, the seller can transfer, and the creditors of the seller can reach, the account or chattel paper as if it had not been sold.

Example: Debtor sells accounts or chattel paper to Buyer-1 and retains no interest in them. Buyer-1 does not file a financing statement. Debtor then sells the same receivables to Buyer-2. Buyer-2 files a proper financing statement. Having sold the

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receivables to Buyer-1, Debtor would not have any rights in the collateral so as to permit Buyer-2's security (ownership) interest to attach. Nevertheless, under this section, for purposes of determining the rights of purchasers for value from Debtor, Debtor is deemed to have the rights that Debtor sold. Accordingly, Buyer-2's security interest attaches, is perfected by the filing, and, under Section 9-322, is senior to Buyer-1's interest.

~~**4. Effect of Perfection. If the security interest of a buyer of accounts or chattel paper is perfected the usual result would take effect: transferees from and creditors of the seller could not acquire an interest in the sold accounts or chattel paper. The same result generally would occur if payment intangibles or promissory notes were sold, inasmuch as the buyer's security interest is automatically perfected under Section 9-309. However, in certain circumstances a purchaser who takes possession of a promissory note will achieve priority, under Sections 9-330 or 9-331, over the security interest of an earlier buyer of the promissory note. It necessarily follows that the seller in those circumstances retains the power to transfer the promissory note, as if it had not been sold, to a purchaser who obtains priority under either of those sections. See Section 9-203(b)(3), Comment 6.**~~

4. **Effect of Perfection.** If the security interest of a buyer of accounts or chattel paper is perfected, ordinarily transferees from and creditors of the seller cannot later acquire an interest in an item so sold because, after the security interest is perfected, the seller no longer has a legal or equitable interest in the item. This does not always mean, however, that the seller cannot thereafter create a security interest in the item. A debtor may create a security in an item of property if it has either "rights in the collateral" or "the power to transfer rights in the collateral. See Section 9-203(b)(2). One example of a situation in which a debtor has the power to transfer rights in an account or an item of chattel paper--and, thus, to create a security interest in it--even after the account or chattel paper has been sold and the buyer has perfected its security interest is provided in Section 9-203, Comment 6, Example 2 (describing a transaction in which the post-sale security interest was perfected by a financing statement filed before the sale).

See PEB Commentary No. 29, dated February 27, 2025. The Commentary is available at https://www.ali.org/peb-ucc.

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Unif. Commercial Code § 9-318, ULA UCC § 9-318

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201 A.D.3d 752
Supreme Court, Appellate Division,
Second Department, New York.

PRINCIPIS CAPITAL, LLC, appellant,
v.
I DO, INC., et al., respondents.

2018–12193
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(Index No. 517860/17)
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Submitted—October 25, 2021
|
January 12, 2022

Synopsis

Background: Buyer of interest in corporate seller's future receivables brought breach of contract action against seller. The Supreme Court, Kings County, Pamela L. Fisher, J., denied buyer's motion for summary judgment. Buyer appealed.

The Supreme Court, Appellate Division, held that transaction set forth in parties' agreement was not a loan subject to usury laws.

Reversed.

Procedural Posture(s): On Appeal; Motion for Summary Judgment.

Attorneys and Law Firms

Platzer, Swergold, Levine, Goldberg, Katz & Jaslow, LLP, New York, NY (Andrew S. Muller of counsel), for appellant.

MARK C. DILLON, J.P., BETSY BARROS, LINDA CHRISTOPHER, JOSEPH A. ZAYAS, JJ.

****326** DECISION & ORDER

***753** In an action, inter alia, to recover damages for breach of contract, the plaintiff appeals from an order of the Supreme Court, Kings County (Pamela L. Fisher, J.), dated May 29, 2018. The order, insofar as appealed from, denied those branches of the plaintiff's motion which were for summary judgment on the complaint and, in effect, for summary judgment dismissing the defendants' affirmative defenses and counterclaims.

ORDERED that the order is reversed insofar as appealed from, on the law, with costs, and those branches of the plaintiff's motion which were for summary judgment on the complaint and, in effect, for summary judgment dismissing the defendants' affirmative defenses and counterclaims are granted.

On or about March 7, 2017, the plaintiff, Principis Capital, LLC and the defendant I Do, Inc. (hereinafter I Do), entered into a written agreement (hereinafter the agreement), pursuant to which I Do sold and the plaintiff purchased an interest in I Do's future receivables for the sum of $38,429.39 (hereinafter the purchase price). In exchange for the purchase price, I Do authorized the plaintiff to debit from I Do's bank account a percentage of I Do's monthly sales revenue, until the plaintiff received the sum of $52,456.12 (hereinafter the purchased amount). I Do also agreed that in the event of its default under the agreement, the full uncollected purchased amount would become immediately due and payable in full to the plaintiff. The defendant Michael Bartels executed a personal guaranty of performance of all the representations, warranties, and covenants made by I Do in the agreement. On or about March 15, 2017, the plaintiff paid I Do the purchase price.

In September 2017, the plaintiff commenced this action, inter alia, to recover damages for breach of contract, alleging that in or about August 2017, I Do, after making approximately $10,183.22 in payments, defaulted and made no further payments. In their answer, the defendants admitted that the plaintiff had paid I Do the sum of $38,429.39, I Do had executed the agreement, and I Do had paid approximately $10,183.22 to the plaintiff, but they denied other material allegations of the complaint and asserted various affirmative defenses and counterclaims. Subsequently, the plaintiff moved, inter alia, for summary judgment on the complaint and, in effect, for summary judgment dismissing the defendants' affirmative defenses and counterclaims. In an order dated May 29, ***754** 2018, the Supreme Court denied the plaintiff's motion. The plaintiff appeals.

On its motion, the plaintiff submitted proof of an executed written contract and proof of the defendants' breach, which the defendant did not dispute. If, however, the agreement was found to be a loan, criminal usury would be a defense to

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its enforcement, rendering it void (*see Davis v. Richmond Capital Group, LLC,* 194 A.D.3d 516, 517, 150 N.Y.S.3d 2). "The rudimentary element of usury is the existence of a loan or forbearance of money, and where there is no loan, there can be no usury, however unconscionable the contract may be" (*LG Funding, LLC v. United Senior Props. of Olathe, LLC,* 181 A.D.3d 664, 665, 122 N.Y.S.3d 309). To determine whether a transaction constitutes ****327** a usurious loan: "The court must examine whether the plaintiff is absolutely entitled to repayment under all circumstances. Unless a principal sum advanced is repayable absolutely, the transaction is not a loan. Usually, courts weigh three factors when determining whether repayment is absolute or contingent: (1) whether there is a reconciliation provision in the agreement; (2) whether the agreement has a finite term; and (3) whether there is any recourse should the merchant declare bankruptcy" (*LG Funding, LLC v. United Senior Props. of Olathe, LLC,* 181 A.D.3d at 665–666, 122 N.Y.S.3d 309 [citations and internal quotation marks omitted]).

Here, the plaintiff established that the transaction set forth in the agreement was not a loan. The terms of the agreement specifically provided for adjustments to the monthly payments made by I Do to the plaintiff based on changes in I Do's monthly sales. Concomitantly, as the amount of the monthly payments could change, the term of the agreement was not finite. Moreover, no contractual provision existed establishing that a declaration of bankruptcy would constitute an event of default (*cf. Davis v. Richmond Capital Group, LLC,* 194 A.D.3d at 517, 150 N.Y.S.3d 2; *LG Funding, LLC v. United Senior Props. of Olathe, LLC,* 181 A.D.3d at 665, 122 N.Y.S.3d 309). Since the plaintiff otherwise established its prima facie entitlement to judgment as a matter of law on the complaint by demonstrating the existence of an agreement and breach, and the defendants failed to raise a triable issue of fact in opposition, the Supreme Court should have granted that branch of the plaintiff's motion which was for summary judgment on the complaint (*see Victory State Bank v. EMBA Hylan, LLC,* 169 A.D.3d 963, 965, 95 N.Y.S.3d 97).

Likewise, as the plaintiff demonstrated its prima facie entitlement to judgment as a matter of law dismissing the defendants' affirmative defenses and counterclaims, and as the ***755** defendants failed to raise a triable issue of fact in opposition (*see Zuckerman v. City of New York,* 49 N.Y.2d 557, 562, 427 N.Y.S.2d 595, 404 N.E.2d 718), the Supreme Court should have granted those branches of the plaintiff's motion which were, in effect, for summary judgment dismissing those affirmative defenses and counterclaims.

DILLON, J.P., BARROS, CHRISTOPHER and ZAYAS, JJ., concur.

All Citations

201 A.D.3d 752, 160 N.Y.S.3d 325, 2022 N.Y. Slip Op. 00203

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181 A.D.3d 664
Supreme Court, Appellate Division,
Second Department, New York.

LG FUNDING, LLC, Appellant,
v.
UNITED SENIOR PROPERTIES OF OLATHE, LLC, etc., et al., Respondents.

2018–09950
|
(Index No. 500056/18)
|
Submitted—June 3, 2019
|
March 11, 2020

Synopsis

Background: Buyer commenced action against seller to recover damages for breach of contract in wherein buyer agreed to purchase seller's future receivables. Seller asserted various affirmative defenses and counterclaimed alleging that transaction at issue was a criminally usurious loan. Buyer moved to dismiss seller's affirmative defenses and counterclaim, and for summary judgment. The Supreme Court, Kings County, Pamela L. Fisher, J., denied buyer's motion. Buyer appealed.

Holdings: The Supreme Court, Appellate Division, held that:

transaction constituted a loan for purposes of seller's affirmative defenses;

buyer failed to establish its entitlement to judgment as a matter of law; and

dismissal of seller's counterclaim was required.

Affirmed as modified.

Procedural Posture(s): On Appeal; Motion to Dismiss; Motion to Dismiss for Failure to State a Claim; Motion for Summary Judgment.

Attorneys and Law Firms

***311** Gene Rosen's Law Firm, a Professional Corporation, Kew Gardens Hills, N.Y. (Gene W. Rosen and Matin Emouna of counsel), for appellant.

ALAN D. SCHEINKMAN, P.J., SYLVIA O. HINDS–RADIX, HECTOR D. LASALLE, BETSY BARROS, JJ.

DECISION & ORDER

In an action, inter alia, to recover damages for breach of contract, the plaintiff appeals from an order of the Supreme Court, Kings County (Pamela L. Fisher, J.), dated May 7, 2018. The order denied the plaintiff's motion pursuant to CPLR 3211(a) to dismiss the defendants' affirmative defenses and counterclaim, and for summary judgment on the complaint.

ORDERED that the order is modified, on the law, by deleting the provision thereof denying that branch of the plaintiff's motion which was pursuant to CPLR 3211(a) to dismiss the counterclaim, and substituting therefor a provision granting that branch of the motion; as so modified, the order is affirmed, with costs to the plaintiff.

On February 7, 2017, the plaintiff and the defendant United Senior Properties of Olathe, LLC (hereinafter United), entered into a written merchant agreement (hereinafter the agreement), pursuant to which United sold and the plaintiff purchased United's future receivables for the sum of $100,990 (hereinafter the purchase price). In exchange for the purchase, United was obligated to authorize the plaintiff to debit from United's bank account 15% of United's daily revenue, capped at $2,499 per week, until the plaintiff received the sum of $129,267.20 (hereinafter the purchased amount). United also agreed that in the event of its default under the agreement, the full uncollected purchased amount plus all fees due under the agreement, including reasonable attorneys' fees, would become immediately due and payable in full to the plaintiff. The defendants Linda Julian and Paul Thoma executed a personal guaranty of performance of all the representations, warranties, and covenants made by United in the agreement. On February 9, 2017, the plaintiff paid United the purchase price.

In July 2017, the plaintiff commenced this action, inter alia, to recover damages for breach of contract. In their

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answer, the defendants denied the material allegations of the complaint and asserted various affirmative defenses and a counterclaim alleging ***312** that the transaction at issue was a criminally usurious loan. Subsequently, the plaintiff moved pursuant to CPLR 3211(a)(1) and (7) to dismiss the defendants' affirmative defenses and counterclaim alleging that the transaction was a criminally usurious loan, and for summary judgment on the complaint. In an order dated May 7, 2018, the Supreme Court denied the plaintiff's motion. The plaintiff appeals.

"In reviewing a motion to dismiss an affirmative defense, the court must liberally construe the pleadings in favor of the party asserting the defense and give that party the benefit of every reasonable inference" (*Bank of N.Y. v. Penalver*, 125 A.D.3d 796, 797, 1 N.Y.S.3d 825 [internal quotation marks omitted]). "[I]f there is any doubt as to the availability of a defense, it should not be dismissed" (*Wells Fargo Bank, N.A. v. Rios*, 160 A.D.3d 912, 913, 74 N.Y.S.3d 321). Dismissal may be warranted under CPLR 3211(a)(1) "if the documentary evidence submitted conclusively establishes a defense to the asserted claims as a matter of law" (*Leon v. Martinez*, 84 N.Y.2d 83, 88, 614 N.Y.S.2d 972, 638 N.E.2d 511). "When assessing a motion to dismiss a complaint or counterclaim ... for failure to state a cause of action, the court must afford the pleading a liberal construction, accept as true all facts as alleged in the pleading, accord the pleader the benefit of every possible inference, and determine only whether the facts as alleged fit within any cognizable legal theory" (*V. Groppa Pools, Inc. v. Massello*, 106 A.D.3d 722, 722, 964 N.Y.S.2d 563; *see* CPLR 3211[a][7]; *Dorce v. Gluck*, 140 A.D.3d 1111, 1112, 34 N.Y.S.3d 501).

The rudimentary element of usury is the existence of a loan or forbearance of money, and where there is no loan, there can be no usury, however unconscionable the contract may be (*see Seidel v. 18 E. 17th St. Owners*, 79 N.Y.2d 735, 586 N.Y.S.2d 240, 598 N.E.2d 7; *Abir v. Malky, Inc.*, 59 A.D.3d 646, 649, 873 N.Y.S.2d 350). To determine whether a transaction constitutes a usurious loan, it "must be 'considered in its totality and judged by its real character, rather than by the name, color, or form which the parties have seen fit to give it' " (*Abir v. Malky, Inc.*, 59 A.D.3d at 649, 873 N.Y.S.2d 350, quoting *Ujueta v. Euro–Quest Corp.*, 29 A.D.3d 895, 895, 814 N.Y.S.2d 551 [internal quotation marks omitted]). The court must examine whether the plaintiff "is absolutely entitled to repayment under all circumstances" (*K9 Bytes, Inc. v. Arch Capital Funding, LLC*, 56 Misc.3d 807, 816, 57 N.Y.S.3d 625 [Sup. Ct. Westchester County]). Unless a principal sum advanced is repayable absolutely, the transaction is not a loan (*see Rubenstein v. Small*, 273 App.Div. 102, 75 N.Y.S.2d 483). Usually, courts weigh three factors when determining whether repayment is absolute or contingent: (1) whether there is a reconciliation provision in the agreement; (2) whether the agreement has a finite term; and (3) whether there is any recourse should the merchant declare bankruptcy (*see K9 Bytes, Inc. v. Arch Capital Funding, LLC*, 56 Misc.3d at 816–819, 57 N.Y.S.3d 625; *see also Funding Metrics, LLC v D & V Hospitality, Inc.*, 62 Misc.3d 966, 91 N.Y.S.3d 678, 970 [Sup. Ct. Westchester County]).

Here, with respect to a reconciliation provision, the agreement provides that the plaintiff "may, upon [United's] request, adjust the amount of any payment due under this Agreement at [its] *sole discretion* and as it deems appropriate" (emphasis added). The agreement also contains provisions suggesting that United's obligation to repay was absolute and not contingent on its actual accounts receivable. ***313** In this regard, the agreement provides that United's written admission of its inability to pay its debt or its bankruptcy constitute events of default under the agreement, which entitle the plaintiff to the immediate full repayment of any of the unpaid purchased amount (*cf. Champion Auto Sales, LLC v. Pearl Beta Funding, LLC*, 159 A.D.3d 507, 69 N.Y.S.3d 798). The agreement provides that in the event United files for bankruptcy or is placed under an involuntary filing, the plaintiff would be entitled to enforce the provisions of the personal guaranty executed by Julian and Thoma, United would be required to deliver to the plaintiff a confession of judgment in the amount of the purchased amount, and the plaintiff would be allowed to enter the confession of judgment as a judgment. These provisions suggest that the plaintiff did not assume the risk that United would have less-than-expected or no revenues. Thus, we agree with the Supreme Court's determination denying that branch of the plaintiff's motion which was pursuant to CPLR 3211(a)(1) and (7) to dismiss the affirmative defenses alleging that the transaction at issue is a criminally usurious loan.

Since the plaintiff failed to demonstrate the absence of triable issues of fact as to whether the transaction constitutes a criminally usurious loan, we agree with the Supreme Court's determination denying that branch of the plaintiff's motion which was for summary judgment on the complaint.

However, the Supreme Court should have granted that branch of the plaintiff's motion which was pursuant to CPLR 3211(a)(7) to dismiss the counterclaim, alleging criminal usury.

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Although the defendants may assert criminal usury as an affirmative defense (*see* General Obligations Law § 5–521[3]; Limited Liability Company Law § 1104[c]; Penal Law § 190.40; *Fred Schutzman Co. v Park Slope Advanced Med., PLLC*, 128 A.D.3d 1007, 1008, 9 N.Y.S.3d 682; *Blue Wolf Capital Fund II, L.P. v American Stevdoring, Inc.*, 105 A.D.3d 178, 184, 961 N.Y.S.2d 86; *Nikezic v. Balaz*, 184 A.D.2d 684, 685, 585 N.Y.S.2d 86; *Intima–Eighteen, Inc. v. Schreiber Co.*, 172 A.D.2d 456, 457, 568 N.Y.S.2d 802), they may not assert criminal usury as the basis for a counterclaim (*see Intima–Eighteen, Inc. v. Schreiber Co.*, 172 A.D.2d at 457, 568 N.Y.S.2d 802).

SCHEINKMAN, P.J., HINDS–RADIX, LASALLE and BARROS, JJ., concur.

All Citations

181 A.D.3d 664, 122 N.Y.S.3d 309, 2020 N.Y. Slip Op. 01607

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8 Cal.4th 791
Supreme Court of California, In Bank.

Edward T. GHIRARDO et al., Plaintiffs,
Cross-defendants and Respondents,
v.
Ronald F. ANTONIOLI et al., Defendants,
Cross-complainants and Appellants.

No. S032435
|
Nov. 28, 1994.
|
As Modified on Denial of Rehearing Feb. 2, 1995.

Synopsis

Purchasers of real property subject to preexisting deed of trust brought action against holders of deed claiming that settlement transaction and resultant notes in connection with dispute regarding payments assertedly owed on note secured by deed were usurious. The Superior Court, Marin County, No. 139540, John Keane, J. pro tem., entered judgment for purchasers. Holders appealed. The Court of Appeal affirmed and remanded. Review was granted, superseding the opinion of the Court of Appeal. The Supreme Court, Baxter, J., held that: (1) trial court's finding of usury was mixed question of law and fact, subject to Supreme Court's independent review; (2) settlement notes were neither "loan" nor "forebearance," but instead modification of credit sale and were not subject to usury laws; and (3) remand was required for consideration of whether because holder of deed had reconveyed deed of trust to purchaser, vendor could no longer judicially foreclose on property and could not obtain deficiency judgment under California's one form of action rule.

Judgment of Court of Appeal reversed and matter remanded.

Mosk, J., dissented and filed opinion.

Opinion, 17 Cal.Rptr.2d 664, vacated.

Procedural Posture(s): On Appeal.

Attorneys and Law Firms

***794** ****963** *****421** Richard A. Hirsch, Novato, for defendants, cross-complainants and appellants.

***795** Howard, Rice, Nemerovski, Canady, Robertson & Falk, Steven E. Schon, Laurence F. Pulgram, San Francisco, Bowles & Verna, Richard T. Bowles, K.P. Dean Harper and Thomas G.F. Del Beccaro, Walnut Creek, for plaintiffs, cross-defendants and respondents.

Opinion

BAXTER, Justice.

This case demonstrates the complexity, uncertainty, and sometimes unexpected results of California's usury law. The owners of undeveloped real property sold it to a prospective developer and received a promissory note and deed of trust to the property. The new owner sold it to another buyer, who purchased it subject to that note and deed of trust. No one contends either of these transactions was usurious. A payment dispute arose, and the new buyer sued the first seller to prevent foreclosure. After extensive negotiations, the parties agreed to a debt restructuring. The buyer paid the new obligation (except for a portion still in dispute), then claimed usury and sued the first seller.

The trial court found that "the parties on both sides were sophisticated, familiar with the world of land transactions and financial dealings. One of the plaintiffs [buyers] is an attorney, another a certified public accountant. Defendants at all times during negotiations were represented by able counsel. Both sides fully participated in the negotiations which resulted in the settlement agreement. It is clear from the evidence that none of the parties on either side thought of the possibility of usury." The court concluded, however, that the usury law nonetheless applied and awarded the buyer all interest paid under the restructured debt plus attorney fees.

As we shall explain, we hold the usury law does not apply to this debt restructuring because there was no loan or forbearance, the prerequisite to application of the usury law. The transaction was a modification of a credit sale that was not subject to the usury proscription. The modification retained the exemption.

FACTS

1. The transactions

Petitioners Ronald and Pamela Antonioli (hereafter collectively referred to as Antonioli) bought a 20–acre parcel of undeveloped real property in Novato, California

in December 1981 from McPhail's, Inc. (McPhail), giving McPhail a purchase-money promissory note for $618,919 (the Antonioli note) secured by a first deed of trust on the property (the Antonioli deed of trust). The Antonioli note was due in December 1984.

***796** In July 1984, Antonioli sold the property to Philip Gay Associates (Gay), receiving a promissory note for $1,745,000 (the Gay note) secured by a second deed of trust (the Gay deed of trust). The Gay note was an all-inclusive note, i.e., "wrap-around," that included in its principal the unpaid balance still due McPhail under the Antonioli note. Gay made payments to Antonioli under the Gay note, and Antonioli continued to pay McPhail under the Antonioli note. The Gay deed of trust was subordinate and subject to the Antonioli deed of trust.

Before escrow closed on his purchase of the property, Gay contracted to sell it to Edward Ghirardo and the other respondents (hereafter collectively referred to as Ghirardo). Ghirardo paid more than $650,000 in cash, executed a $200,000 promissory note (the Ghirardo note) and accompanying third deed of trust to Gay (the Ghirardo deed of trust), and took the property subject to the existing Gay note and deed of trust in its original sum of $1,745,000. No documents were executed between Antonioli and Ghirardo in connection with this sale. Ghirardo was not a party to either the Gay note and deed of trust or the Antonioli note and deed of trust.

****964 ***422 2. The dispute and settlement**

A dispute arose in 1986 between Antonioli and Ghirardo regarding payments allegedly owing to Antonioli on the Gay note. (After Ghirardo purchased the property from Gay, Ghirardo had begun paying directly to Antonioli the payments owed by Gay. This eliminated the need for Ghirardo to pay Gay, who would in turn have to remit the payment to Antonioli.) Antonioli began nonjudicial foreclosure proceedings. Ghirardo sued to enjoin the foreclosure and obtained a temporary restraining order. After a trial court hearing on Ghirardo's request for a preliminary injunction and before decision, the parties reached a settlement agreement that resulted in a restructuring of the debt and dismissal of Ghirardo's action to enjoin the foreclosure.

Under the settlement, Antonioli canceled the Gay note and reconveyed the Gay deed of trust. In exchange, Ghirardo agreed to pay $342,500 in cash and to execute two new secured notes payable to Antonioli in the amounts of $57,500 (the small note) and $1,072,867.47 (the large note). (For convenience we will hereafter occasionally refer to the two notes as "the settlement notes" or the "debt restructuring.") Ghirardo also agreed, "as and for consideration of this new Note," to pay a $100,000 fee, which the agreement ***797** stated was to be "added to the principal of the [large] note." [1] The small note bore interest at the stated rate of 13 percent. The large note stated a 10 percent interest rate, but with the $100,000 fee included in the principal, the effective rate of interest was 17.46 percent. When the notes were executed, the maximum permissible rate was 10.5 percent. Ghirardo also agreed to pay $45,000 in attorney fees to Antonioli.

Ghirardo paid the small note in full (including $4,362.12 in interest) and paid the total amount due under the large note (including $94,338.09 in interest), except for $151,566.82 that Antonioli inadvertently omitted from his payoff demand to the escrow holder. Antonioli's counsel promptly discovered this mistake and informed the escrow holder, but escrow had already closed. Antonioli informed Ghirardo of the error and requested payment of the additional amount. Ghirardo responded by stating his view, apparently for the first time, that both the large and the small notes were usurious. He demanded that Antonioli repay all interest paid on the notes. Antonioli declined.

3. The trial and appeal

Ghirardo filed this action, contending the settlement notes were usurious. He sought damages including treble the amount of interest paid, prejudgment interest, and attorney fees. Antonioli cross-complained for the balance allegedly due on the large note. After a bench trial, the court found the settlement transaction constituted both a loan and a forbearance and was usurious. More specifically, the small note ($57,500) was usurious on its face, and the large note ($1,072,867.47) became usurious when the $100,000 additional charge was added to the amount of that note. The trial court found the $100,000 charge was a "fee, bonus, commission or other compensation for forbearance and extension of credit" and was, therefore, interest despite its characterization in the parties' agreement as being principal.

The court awarded Ghirardo $98,700.26 in actual interest paid on the notes. The court also awarded Ghirardo $31,260.96 in prejudgment interest (Civ.Code, § 3287), and $76,350 in attorney fees (Civ.Code, § 1717). The court, however, declined to award treble damages. The court also entered judgment against Antonioli on his cross-complaint, finding: (1) that the amount sought was usurious interest rather than

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principal, and (2) that ***798** Antonioli had not complied with the one-form-of action rule set forth in Code of Civil Procedure section 726. The Court of Appeal affirmed.

**965 ***423 DISCUSSION

1. The framework

The California Constitution, article XV, section 1, states "No person, association, copartnership or corporation shall by charging any fee, bonus, commission, discount or other compensation receive from a borrower more than the interest authorized by this section upon any loan or forbearance of any money, goods or things in action."[2] The essential elements of usury are: (1) The transaction must be a loan or forbearance; (2) the interest to be paid must exceed the statutory maximum; (3) the loan and interest must be absolutely repayable by the borrower; and (4) the lender must have a willful intent to enter into a usurious transaction. (See generally, 4 Miller & Starr, Cal.Real Estate Law (2d ed. 1989) § 10:2, p. 650 [hereafter Miller & Starr]; Comment, *A Comprehensive View of California Usury Law* (1974) 6 Sw.U.L.Rev. 166, 174.) The element of intent is narrow. "[T]he intent sufficient to support the judgment [of usury] does not require a conscious attempt, with knowledge of the law, to evade it. The conscious and voluntary taking of more than the legal rate of interest constitutes usury and the only intent necessary on the part of the lender is to take the amount of interest which he receives; if that amount is more than the law allows, the offense is complete." (*Thomas v. Hunt Mfg. Co.* (1954) 42 Cal.2d 734, 740, 269 P.2d 12.) Intent is relevant, however, in determining the true purpose of the transaction in question because "... the trier of fact must look to the substance of the transaction rather than to its form.... '[I]t is for the trier of the fact to determine whether the intent of the contracting parties was that disclosed by the form adopted, or whether such form was a mere sham and subterfuge to cover up a usurious transaction.' " (*West Pico Furniture Co. v. Pacific Finance Loans* (1970) 2 Cal.3d 594, 603, 86 Cal.Rptr. 793, 469 P.2d 665, quoting *Janisse v. Winston Investment Co.* (1957) 154 Cal.App.2d 580, 582, 317 P.2d 48.) A transaction is rebuttably presumed *not* to be usurious. (*Janisse v. Winston Investment Co., supra,* 154 Cal.App.2d 580, 586, 317 P.2d 48; ***799** *Rose v. Wheeler* (1934) 140 Cal.App. 217, 220, 35 P.2d 220; see generally, 4 Miller & Starr, *supra,* § 10:2, p. 650.) The borrower bears the burden of proving the essential elements of a usurious transaction. (*Terry Trading Corp. v. Barsky* (1930) 210 Cal. 428, 433, 292 P. 474; *Sandell, Inc. v. Bailey* (1963) 212 Cal.App.2d 920, 931–932, 28 Cal.Rptr. 413.)

2. The proper standard of appellate review

Ghirardo asserts the question of whether a transaction is usurious is a question of fact and that a reviewing court's role is limited to deciding whether the trial court's findings are supported by substantial evidence. Ghirardo contends we must uphold the trial court's finding of usury because substantial evidence supports the finding. Antonioli responds that the substantial evidence standard does not govern because the facts are undisputed. Antonioli is correct. The trial court's finding of usury is subject to our independent review for two reasons.

First, Ghirardo acknowledges that "The facts most relevant to this appeal are *undisputed.*" (Italics added.) When the decisive facts are undisputed, we are confronted with a question of law and are not bound by the findings of the trial court. (*Mole–Richardson Co. v. Franchise Tax Bd.* (1990) 220 Cal.App.3d 889, 894, 269 Cal.Rptr. 662; see generally 9 Witkin, Cal.Procedure (3d ed. 1988) Appeal, § 278, p. 289 ["*Where the evidence is in conflict,* the appellate court will not disturb the verdict of the jury or the findings of the trial court." (Other italics omitted.)].) We see no reason why this well-established rule should not apply to usury ****966** *****424** cases. In *DCM Partners v. Smith* (1991) 228 Cal.App.3d 729, 278 Cal.Rptr. 778, the Court of Appeal reversed a trial court finding of usury based, as in this case, on undisputed facts. (See also 4 Miller & Starr, *supra,* § 10:2, p 648 ["[T]he issue of usury is a *question of law* if the evidence is undisputed."].)

Second, we are not persuaded the substantial evidence standard is as broad as may have previously been suggested. Ghirardo is correct that we have stated, "Whether a particular transaction is a usurious loan or a sale is a question of fact." (*West Pico Furniture Co. v. Pacific Finance Loans, supra,* 2 Cal.3d 594, 603, 86 Cal.Rptr. 793, 469 P.2d 665 [*West Pico*].) Properly understood, however, that characterization does not mean the question of whether a transaction is subject to the usury law is necessarily and in all respects a question of fact. *West Pico* itself makes that point. Although we upheld the trial court's finding that the purported sales at issue were actually loans, we held them to be exempt from the usury law and reversed the trial court's judgment. *West Pico* thus shows that a trial court's finding of usury is not the last word. Moreover, as we later explained, "In all such [i.e., usury] cases the issue is whether or not the ***800** bargain of the parties, assessed in light of all the circumstances and with a view to substance rather than form, has as its true object the hire of money

at an excessive rate of interest. [Citation.] The existence of the requisite intent is always a question of fact." (*Boerner v. Colwell Co.* (1978) 21 Cal.3d 37, 44, 145 Cal.Rptr. 380, 577 P.2d 200.) The circumstances giving rise to the transaction in dispute—including whether the parties intended a loan rather than a sale—are generally disputed by the parties. A question of disputed intent, in particular, is rooted in the facts of the case. The court must therefore determine the true nature of the transaction. (*West Pico, supra,* 2 Cal.3d at pp. 603–604, 86 Cal.Rptr. 793, 469 P.2d 665.) It is that determination which presents a question of fact.

The question of usury, however, also can require more than a factual determination of who did what and why they did it. Once the historical facts of the transaction are determined, the question of whether *that type of transaction* is subject to the usury proscription is a question of law. For example, in *Southwest Concrete Products v. Gosh Construction Corp.* (1990) 51 Cal.3d 701, 274 Cal.Rptr. 404, 798 P.2d 1247, the nature of the transaction had been decided by the trier of fact to be an interest payment on an overdue commercial account. The question before us was whether that type of transaction was subject to the usury law. We did not treat that issue as being a question of fact. And as noted above, in *West Pico, supra,* 2 Cal.3d 594, 86 Cal.Rptr. 793, 469 P.2d 665, the trial court had found the transaction to be a loan, but we concluded it was of a type that was exempt from the usury law.

The foregoing cases suggest that the question of whether a transaction is usurious is generally a mixed question of fact and law. As explained in a nonusury case, "There are three steps involved in deciding a mixed fact/law question. The first step is the establishment of basic, primary or historical facts. The second is the selection of the applicable law. The third is the application of law to the facts. All three trial court determinations are subject to appellate review. Questions of fact are reviewed by giving deference to the trial court's decision. Questions of law are reviewed under a nondeferential standard, affording plenary review. (*People v. Louis* (1986) 42 Cal.3d at p. 985, 232 Cal.Rptr. 110, 728 P.2d 180.) However, as to the third step, the application of law to fact, difficulty is encountered and views as to the correct approach are mixed.... [¶] ' "In our view, the key to the resolution of this question is the nature of the inquiry that is required to decide 'whether the rule of law as applied to the established facts is or is not violated.' [Citation.] If application of the rule of law to the facts requires an inquiry that is 'essentially factual,' [citation]—one that is founded 'on the application of the fact-finding tribunal's experience with the mainsprings of human conduct,' [citation]—the concerns of ***801** judicial administration will favor the [trial] court, and the [trial] court's determination should be classified as one of fact reviewable ****967** under the clearly erroneous *****425** standard. If, on the other hand, the question requires us to consider legal concepts in the mix of fact and law and to exercise judgment about the values that animate legal principles, then the concerns of judicial administration will favor the appellate court, and the question should be classified as one of law and reviewed de novo." ' " (*McGhan Medical Corp. v. Superior Court* (1992) 11 Cal.App.4th 804, 809–810, 14 Cal.Rptr.2d 264, quoting *People v. Louis* (1986) 42 Cal.3d 969, 986–987, 232 Cal.Rptr. 110, 728 P.2d 180, brackets in *McGhan.*)

Applying the foregoing analysis to the present circumstance, we conclude a trial court's determination of the historical basis of the transactions—in common parlance, what happened—raises a question of fact. (As explained above, however, in this case those facts are largely undisputed.) The question, however, of the legal characteristics of that transaction, i.e., whether it was subject to the usury law, requires an application of law to the facts. Whether a type of transaction is subject to usury is a question that can have practical significance far beyond the confines of the case then before the court. (See, e.g., *Southwest Concrete Products v. Gosh Construction Corp., supra,* 51 Cal.3d 701, 274 Cal.Rptr. 404, 798 P.2d 1247 [deciding usury issue of statewide importance].) If such questions were effectively removed from the consideration of the appellate courts, the development and clarification of the important issues affecting commerce would be impeded. Such a question " ' "... requires us to consider legal concepts in the mix of fact and law and to exercise judgment about the values that animate legal principles...." ' " (*McGhan Medical Corp. v. Superior Court, supra,* 11 Cal.App.4th at p. 810, 14 Cal.Rptr.2d 264.) The determination in the present case of whether the debt restructuring is a loan subject to the usury law, rather than being an exempt transaction of a different character, is such a question. We conclude it is a question of law subject to independent review.

For the foregoing reasons, we shall independently determine whether the trial court was correct in finding the settlement notes to be usurious. Moreover, even if the substantial evidence standard applied, under the substantive principles we shall set forth, there was no substantial evidence to support the finding that the settlement was a loan or forbearance.

3. Whether the settlement was a loan or forbearance

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The constitutional proscription against usury applies by its express terms only to a "... loan or forbearance of any money, goods or things in action." (Cal.Const., art. XV, § 1.) Without a loan or forbearance, usury ***802** cannot exist. (*Southwest Concrete Products v. Gosh Construction Corp., supra,* 51 Cal.3d 701, 705, 274 Cal.Rptr. 404, 798 P.2d 1247 (*Southwest Concrete*); see generally 4 Miller & Starr, *supra,* § 10:3, p 651; ["The first essential element of a usurious transaction is a loan or forbearance of money."]; Comment, *A Comprehensive View of California Usury Law, supra,* 6 Sw.U.L.Rev. 166, 175 ["It is imperative to remember that there must always be a lending or forbearance ... for the question of usury to arise."].) Antonioli contends the settlement transaction was neither a loan nor a forbearance. We agree.

Viewed in the context of the transactions leading to this action, the settlement notes bear none of the attributes of a loan. To paraphrase Justice Mosk's often-quoted invocation of folk wisdom, if it does not look like a duck, does not walk like a duck, and does not quack like a duck, it is not likely to be a duck. (*In re Deborah C.* (1981) 30 Cal.3d 125, 141, 177 Cal.Rptr. 852, 635 P.2d 446 (conc. opn. of Mosk, J.); *Phillippe v. Shapell Industries* (1987) 43 Cal.3d 1247, 1256, 241 Cal.Rptr. 22, 743 P.2d 1279.) We are not suggesting that courts should not look beyond the surface of a transaction. To the contrary, "Sensitive to the ingenuity and creativity of those entrepreneurs willing to engage in legal brinkmanship to maximize profits, courts have carefully scrutinized the form of seemingly innocuous commercial transactions to determine whether the substance amounts to a usurious arrangement." (*DCM Partners v. Smith, supra,* 228 Cal.App.3d 729, 733, 278 Cal.Rptr. 778; ****968** *****426** *Southwest Concrete, supra,* 51 Cal.3d 701, 705, 274 Cal.Rptr. 404, 798 P.2d 1247.) Nevertheless, when the transaction bears none of the indicia of a loan, and, as in this case, there has been a finding that "... none of the parties on either side thought of the possibility of usury," we are reluctant to characterize the transaction as a loan. Doing so would be the judicial equivalent of pounding a square peg into a round hole. Ghirardo fails to meet his burden of establishing that the two settlement notes were loans or forebearances.

Ghirardo contends the restructuring—that is, the execution of the two notes—effected a constructive transfer of funds by Antonioli on behalf of Ghirardo and created a debtor and creditor relationship between himself and Antonioli. Ghirardo's premise is that such a relationship establishes a loan. That is too broad. To be sure, "A loan transaction contemplates a debtor-creditor relationship with an obligation of the 'debtor' to repay the amount of the loan to the creditor...." (4 Miller & Starr, *supra,* § 10:3, p 651.) The converse, however, is not necessarily true. The creation of a debtor-creditor relationship does not, without more, constitute a loan. Antonioli transferred his interest in the real property to Gay in exchange for his promissory note and deed of trust. There was no loan, only a sale. (*Boerner v. Colwell Co., supra,* 21 Cal.3d 37, 47, 145 Cal.Rptr. 380, 577 P.2d 200.) The same was true of the transfer from Gay to Ghirardo. These sales were exempt from the ***803** usury law under the "credit-sale" or "time-price" doctrine. "This doctrine applies when property is sold on credit as an advance over the cash price. In these circumstances, the seller finances the purchase of property by extending payments over time and charging a higher price for carrying the financing. This type of transaction, often called a bona fide credit sale, is not subject to the usury law because it does not involve a loan or forbearance." (*Southwest Concrete, supra,* 51 Cal.3d at p. 705, 274 Cal.Rptr. 404, 798 P.2d 1247; *Boerner v. Colwell Co., supra,* 21 Cal.3d at p 45, 145 Cal.Rptr. 380, 577 P.2d 200; *Verbeck v. Clymer* (1927) 202 Cal. 557, 563, 261 P. 1017; Cal.Real Property Financing (Cont.Ed.Bar 1988) § 5.46, p. 264.) Ghirardo does not dispute the continued validity of this long-standing doctrine. The question is whether the settlement notes come within this exemption from the usury law.

The focus of the parties' disagreement on this question is *DCM Partners v. Smith, supra,* 228 Cal.App.3d 729, 278 Cal.Rptr. 778 (*DCM*), in which the owner of real property sold it in exchange for a promissory note and deed of trust from the buyer. That transaction was exempt as a bona fide credit sale. When the buyer thereafter became unable to pay the note when due, the buyer requested an extension of the maturity date. The seller agreed in exchange for a 50 percent increase in the interest rate, from 10 percent to 15 percent. The buyer paid the extended note, then filed an action claiming usury. The Court of Appeal held that usury law does *not* apply "... to a modified purchase money secured note initially created in an exempt transaction, the bona fide sale and purchase of real property, where the modification, done at the request of the trustor, consisted solely of increasing the rate of interest to reflect market conditions in consideration of extending the due date of the note." (*Id.,* at p. 732, 278 Cal.Rptr. 778.) The Court of Appeal in the present case both rejected and distinguished *DCM's* reasoning. As we shall explain, we believe *DCM* represents the better view and that it properly applies to this case.

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We begin with the important premise, which Ghirardo does not dispute, that his purchase of the property from Gay was exempt from the usury law. (Indeed, Ghirardo's note to Gay bore an interest rate of 11.5 percent and would have been usurious if not exempt.) Nor is there any question that Antonioli's prior sale to Gay was also exempt. Neither transaction involved a loan or forbearance. If Gay defaulted (as a result of Ghirardo's alleged default to Gay), Antonioli had two practical alternatives: (1) he could foreclose the property; or (2) he could agree to replace the Gay note with a new note that extended the time for payment. Antonioli initially chose the former, but Ghirardo agreed to the latter for the obvious reason that foreclosure would have resulted in the loss of his property. Ghirardo now contends ****969 ***427** Antonioli should be punished because he allowed Ghirardo to keep his property. This is hardly a sympathetic argument.

***804** We are not persuaded that a modification of a nonusurious transaction—a credit sale—should be subject to usury. The underlying policy of the credit-sale exemption is that, " 'On principle and authority, the owner of property, whether real or personal, has a perfect right to name the price on which he is willing to sell, and to refuse to accede to any other. He may offer to sell at a designated price for cash or at a much higher price on credit, and a credit sale will not constitute usury however great the difference between the two prices....' " (*Boerner v. Colwell Co., supra,* 21 Cal.3d 37, 45, 145 Cal.Rptr. 380, 577 P.2d 200; quoting *Verbeck v. Clymer, supra,* 202 Cal. 557, 562, 261 P. 1017.)

We see no practical reason why the same rule should not obtain when the seller has already transferred title and is about to foreclose on the purchase money note. Just as he had an initial right to sell the property on any price terms he wished, he has the right to foreclose and to resell the property as he sees fit, at any interest rate, including reselling to the initial buyer. Precluding him from renegotiating with the buyer would elevate form over substance.

Ghirardo, however, contends the credit-sale exemption should not apply because at the time of the modification, Antonioli had nothing to sell, that is, he already had sold the property to Gay. We believe the *DCM* court, *supra,* 228 Cal.App.3d at p. 739, 278 Cal.Rptr. 778, stated the better view: "In saying Smith [the original seller] had nothing to sell[,] DCM wishes to minimize the value of Smith's 'right to foreclose.' While there is a significant difference between a trustor of a secured note and an equity owner of improved real property, the latter status can be readily achieved by the former in a case like the one before us. Had the Smiths declined DCM's invitation to renegotiate they would have entered DCM's default when it failed to make the balloon payment on the due date of the note and foreclosed on the property. At a modest cost the Smiths would have become owners in the property with DCM losing its payments on principal and any increased equity resulting from appreciation. Thus the same factors influencing the Smiths' initial decision to sell were present when they later agreed to renegotiate the note. These factors included the parties' respective desires to be an equity owner of improved real property or a secured lender, interest rates on loans available from institutional lenders and tax benefits such as the deferral of gain to the seller on an installment sale and the deductions available to the buyer for interest payments. From our perspective [the] depiction of the parties as being in substantially different circumstances when they renegotiated the secured note compared to their position at the time of initial sale is not borne out by the realities of the transaction."

Such result would also be unnecessary to achieve the purpose of the usury law, which is "... to protect the necessitous, impecunious borrower who is ***805** unable to acquire credit from the usual sources and is forced by his economic circumstances to resort to excessively costly funds to meet his financial needs. *Such a person does not have the same need to purchase property,* and he does not need the public policy of the State for protection." (4 Miller & Starr, *supra,* § 10:4, p. 656, italics added, fn. omitted.) As Ghirardo himself acknowledges, "Parties buying property are under no compulsion to accept a high rate of interest; they can simply walk away if they cannot afford the price." The same can be said of a land developer like Ghirardo. He was under no compulsion to buy the property, including its being subject to the Gay note to Antonioli. When his development plans went awry, he could simply have walked away. Instead, he wanted to keep the property and agreed to retain it on new terms, in effect substituting his seller (Gay) with another, prior seller (Antonioli). We see no dispositive difference between this transaction and the initial, exempt sale.

Ghirardo disagrees, contending that, although he did not have to buy the property, when the property was being foreclosed he became "the necessitous, impecunious borrower the law intends to protect...." Presumably, he means that because a borrower faced with foreclosure may now lose the ****970 ***428** property, he should somehow be treated differently than when he purchased the property. To be sure, he may lose the property, but he will do so only if the seller forecloses,

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and that is encouraged by the very rule Ghirardo advocates. Unless we were to embrace the notion that commercial transactions are based in altruism, we must reiterate that the seller—who is being defaulted against—has only two options: foreclosure or extension of the note. If, however, an extension will bring the transaction within the usury law, the seller is left with only the foreclosure alternative. " 'The lender who wishes to accommodate the borrower either must force the borrower into a hardship position to pay or lose the security for the loan, or extend the loan and commit usury.... The imposition of the usury limitations in such cases merely harms the impecunious borrower that the law is intended to protect.' " (*DCM, supra,* 228 Cal.App.3d at p. 737, 278 Cal.Rptr. 778, quoting 4 Miller & Starr, *supra,* § 10:12, p. 704.) We agree.

The quoted commentators qualify their support for this view by stating that the extension should be treated as exempt only if the interest rate for the extension stays the same as the original rate or is reduced. (4 Miller & Starr, *supra,* § 10:12, p. 704.) Like the *DCM* court, *supra,* 228 Cal.App.3d at page 737, 278 Cal.Rptr. 778, we reject this qualification. First, it would be unfair to both sides of the transaction. The only alternative to foreclosure for a seller who has suffered a default should not be an extension on more favorable terms to the buyer. That is unfair and impractical. Indeed, for that reason, it also prejudices the buyer who wishes to renegotiate because a seller who has two choices—foreclosure ***806** or extension on new terms favorable only to the buyer—will plainly be more likely to foreclose.

Second, the extension for a *reduced* rate of interest could violate the usury law under Ghirardo's view that an extension of initially exempt debt (e.g., a credit sale) removes the exemption. As the *DCM* court, *supra,* 228 Cal.App.3d 729, 278 Cal.Rptr. 778, explained, under that view, if the new, lower rate of interest was itself above the legal maximum, the extension would be usurious even though the higher, initial rate was not. "It seems to us that the 'law' should function in a rational manner to avoid a somewhat absurd and clearly inequitable result where the parties themselves are unable to distinguish between the bargains except the date on which each was made. Powerful reasons should exist before the law transmutes a legal transaction into an illegal one, particularly where the illegality places the entire financial burden on one party with the other seemingly unjustly enriched by having the benefit of an interest-free loan." (*Id.,* at p. 735, 278 Cal.Rptr. 778.)

Ghirardo not only asks us to reject *DCM, supra,* 228 Cal.App.3d 729, 278 Cal.Rptr. 778, but attempts to distinguish it from the present case on two grounds. First, he points out that in *DCM* the modification was between the original parties to the credit sale, whereas in this case the settlement notes were not between the original parties to the sales, Antonioli and Gay for the first sale, and Gay and Ghirardo for the second sale. We do not see the logic of the distinction. The goals in *DCM* and in this case were the same—to extend the time for payment of notes exempt under the credit-sale doctrine. Moreover, the attempted distinction elevates form over substance. If, under *DCM,* Antonioli could have modified the Gay note to provide an increased rate of interest, we see no reason why Antonioli should not be able to cancel that note and provide the increased rate in a new note.

Second, Ghirardo points to a footnote in *DCM* in which the court noted that, "We wish to emphasize that Smith [the seller] did not receive any additional charges, fees or, consideration [for the modification] other than to increase the interest rate to reflect market conditions." (*DCM, supra,* 228 Cal.App.3d at p. 737, fn. 5, 278 Cal.Rptr. 778.) The *DCM* court also noted that in two prior decisions on which Ghirardo relies, "[T]he beneficiary of the secured note extracted a substantial cash premium as part of the consideration for the modification." (*Id.,* at p. 738, 278 Cal.Rptr. 778.) In the present case, the trial court found that as part of the settlement Ghirardo agreed to pay $100,000, which was a "fee, bonus, commission or other ****971** *****429** compensation for forbearance and extension of credit." Thus, Ghirardo contends *DCM,* even if correct, is distinguishable. We are not persuaded that the noted comments were essential to the *DCM* court's reasoning or that they render *DCM* distinguishable from the present ***807** case. The relevant fact is not how the payments are characterized but whether they are in fact interest. In *DCM* the stated interest rate was increased from 10 percent to 15 percent, a rate that exceeded the legal maximum. In the present case, the asserted maximum rate was exceeded because the $100,000 additional payment was deemed to be additional interest. We do not believe the *DCM* decision would have been different if the 10 percent facial interest rate had remained unchanged, but a bonus payment had increased the effective rate to 15 percent. In either case the relevant figure would have been the 15 percent effective interest.

Moreover, in distinguishing *DCM, supra,* 228 Cal.App.3d 729, 278 Cal.Rptr. 778, the Court of Appeal in the present case seemed to suggest that *DCM* was based on a notion of fairness, including the fact that the increase in that case from

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10 percent to 15 percent exceeded the then-legal maximum of 14 percent by only 1 percent, whereas the rates of 13 percent and 17.46 percent in this case exceeded the 10.5 percent maximum by greater margins. This is not a valid distinction. Whether a transaction violates the usury law does not depend on the margin by which the maximum rate is exceeded. There is no such thing as a little usury.

In short, the settlement and the resulting notes were substantially similar to the credit-sale modification approved in *DCM, supra,* 228 Cal.App.3d 729, 278 Cal.Rptr. 778, and we conclude the rule stated in that case is sound. Thus, the settlement notes were the functional equivalent of a modification to an originally exempt credit sale. Such a modification is not subject to the usury law.

4. Fairness

Although the usury question is not an equitable one, both parties portray themselves as sympathetic victims. Antonioli goes so far as to argue that for public policy reasons the usury law should not protect sophisticated borrowers like Ghirardo. The Court of Appeal properly rejected this argument because we must take the usury law as we find it. Indeed, the usury law is complex and is riddled with so many exceptions that the law's application itself seems to be the exception rather than the rule. (See generally 4 Miller & Starr, *supra,* § 10:20, pp. 761–775 [listing 27 classes of exempt lenders and loans]; Glushon, *The California Usury Law: The Lender's Trap And The Borrower's Windfall* (1968) 43 State Bar.J. 56.) There is, however, no exemption in the usury law for sophisticated borrowers. We decline to create one. On the issue of fairness, however, we do note the trial ***808** court's finding that, "It is clear from the evidence that none of the parties on either side thought of the possibility of usury." [3]

5. Summary as to usury

We hold the settlement notes were neither a loan nor a forbearance within the meaning of usury law. They were instead the functional equivalent of a modification to a credit sale that was exempt from the usury law. Under these circumstances, the settlement notes were not usurious.

6. Antonioli's cross-complaint for affirmative relief

Antonioli contends the trial court erred in denying relief on the cross-complaint seeking reimbursement for the sum omitted from the payoff demand on the large note. The trial court did so on two grounds. First, it found that the amount reflected interest rather than principal and that, because the transaction was usurious, the additional amount was not owed. After our conclusion that the settlement notes were not usurious, that finding no longer supports the trial court's decision. Second, the trial court ****972** *****430** found that the large note was a debt secured by a mortgage on real property and was thus governed by Code of Civil Procedure section 726's one-form-of-action rule, that is, because Antonioli had reconveyed the deed of trust to Ghirardo, Antonioli no longer could judicially foreclose the property and thus could not obtain a deficiency judgment for the amount omitted from the payoff demand. (See, *Security Pacific National Bank v. Wozab* (1990) 51 Cal.3d 991, 999, 275 Cal.Rptr. 201, 800 P.2d 557 ("[S]ection 726 and the statutory scheme of which it is a part require a secured creditor to proceed against the security before enforcing the underlying debt."].) The Court of Appeal properly declined to reach this issue in light of its determination that the settlement notes were usurious. We believe the prudent course is for this court not to decide this issue in the first instance, but to remand to the Court of Appeal to consider the issue in light of our resolution of the usury issue.

7. Award of attorney fees to Ghirardo

The trial court's award of attorney fees was based on Ghirardo's status as the prevailing party under Civil Code section 1717. Antonioli disputed the amount of the award in both the trial court and the Court of Appeal. In this court he no longer challenges the award as being excessive, but in light of our decision that the transaction was not usurious, the award may need to be ***809** reconsidered. (The Court of Appeal's ruling on remand on the cross-complaint may also affect the fee award.) We therefore leave it to the Court of Appeal to decide whether to reexamine the fee award or to remand to the trial court for that purpose.

DISPOSITION

The judgment of the Court of Appeal is reversed. This matter is remanded to the Court of Appeal for further proceedings consistent with this opinion.

LUCAS, C.J., and KENNARD, ARABIAN, GEORGE and WERDEGAR, JJ., concur.

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MOSK, Justice, dissenting.
I dissent.

This case involved a complicated series of transactions involving petitioners (Antonioli), respondents (Ghirardo) and Philip Gay Associates (Gay). As the majority describe the transactions, Antonioli sold a parcel of property to Gay and received a promissory note secured by a second deed of trust; Gay contracted to sell the property to Ghirardo, subject to the existing Gay note and deed of trust. There was no agreement directly between Antonioli and Ghirardo. Nonetheless, as the trial court and the Court of Appeal found, Antonioli looked to Ghirardo for the payments on the Gay note, and when Ghirardo was unable to meet his payments, Antonioli agreed to extend the time for payment of the debt in exchange for an increase in the interest rate and an additional $100,000 fee. Indeed, Antonioli's verified cross-complaint expressly states that the $100,000 fee was "in consideration for the extended term," and the loan documents for the two promissory notes under the settlement specifically recite that they were executed in consideration of the "additional sum of $100,000."

To avoid what it describes as the "sometimes unexpected results of California's usury law," the majority hold that the agreement between Antonioli and Ghirardo was the "functional equivalent of a modification to an originally exempt credit sale"—i.e., the sale transaction between Antonioli and Gay. (Maj. opn., *ante,* p. 430 of 35 Cal.Rptr.2d, p. 972 of 883 P.2d.) Thus, the majority conclude that Ghirardo stepped into Gay's shoes. Relying on a Court of Appeal opinion, the majority hold that a modification to an originally exempt sale transaction is not usurious. (*DCM Partners v. Smith* (1991) 228 Cal.App.3d 729, 278 Cal.Rptr. 778, 278 Cal.Rptr. 778 [*DCM*].)

I disagree with the majority's analysis. I conclude, as did the trial court and the Court of Appeal below, that precisely because Ghirardo effectively ***810** stepped into the shoes of Gay, the $100,000 fee was, in substance, a forbearance, i.e., an extension of time for enforcing the debt on the property. [1] As ****973** *****431** such, the new notes and $100,000 fee were subject to the usury laws.

As I declared in *Southwest Concrete Products,* a forbearance is sufficiently like the act of making a new loan that to ignore it would allow evasion of the interest limitations on the prime target of the usury law, i.e., loans as such. (*Southwest Concrete Products v. Gosh Construction Corp., supra,* 51 Cal.3d at 710, fn. 2, 274 Cal.Rptr. 404, 798 P.2d 1247 (conc. & dis. opn. of Mosk, J.).) The public policy of the usury law supports its application to forbearances, as the facts before us demonstrate. The usury law aims at protecting the borrower from being pressed by economic circumstances to accede to an excessively high interest rate. A forbearance, which involves the extension of time to pay a debt or an agreement not to enforce a claim at its due date, is likely to arise in a situation in which a debtor is having financial difficulty in meeting his debt. Accordingly, the application of the usury laws prevents the holder of a note who agrees to an extension of additional time for repayment from using his unequal bargaining power to impose an additional fee or interest rate that would result in an obligation in excess of the maximum usury limitations.

This case provides an illustration in point. Although Ghirardo was under no economic compulsion to purchase the property in the first instance, at the time of the foreclosure he was no longer bargaining at arm's length. Contrary to the majority's view, Ghirardo could not merely "walk away" without losing a substantial sum, i.e., approximately $1.5 million. Faced with the prospect of such a loss, Ghirardo was under economic pressure to agree to the $100,000 extension fee, even though it effectively resulted in an interest fee in excess of 17 percent, well above the usury rate. In effect, Ghirardo became the "necessitous, impecunious borrower the [usury] law intends to protect." (4 Miller & Starr, Cal.Real Estate Law 2d (1989) § 10.4, p. 659; see *Buck v. Dahlgren* (1972) 23 Cal.App.3d 779, 787, 100 Cal.Rptr. 462.)

To the extent *DCM* can be understood to permit a forbearance that resulted in a usurious interest rate, I would disapprove the decision. In *DCM* the plaintiff had purchased real property in an exempt credit sale, which included a promissory note bearing an interest of 10 percent per annum. When the purchaser could not pay the debt when due, it requested an extension of the maturity date. The seller agreed to extend the note provided the annual interest was increased to 15 percent, the then-prevailing market ***811** rate which exceeded the limit under the usury rate. Emphasizing that the parties had mutually agreed to the increase and were unaware of the usury laws, and that the seller "did not receive any additional charges, fees or consideration other than to increase the rate to reflect market conditions," (228 Cal.App.3d at pp. 732, 737, fn. 5), 278 Cal.Rptr. 778, the Court of Appeal concluded that the transaction was a modification of the exempt credit sale and was therefore not subject to the usury limits.

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I believe *DCM* was wrongly decided. The court correctly found that the agreement to extend the loan was a forbearance. It erred, however, in concluding that the transaction was not usurious because the original loan was exempt and the parties did not knowingly violate the usury laws. As a leading commentator observes, "that reasoning might well excuse numerous types of transactions that would otherwise have been considered usurious." (4 Miller & Starr, Cal.Real Estate Law 2d (1993 pocket supp.) § 10:3, p. 96 [criticizing the decision in *DCM* as "disturbing"].) Moreover, as the majority opinion demonstrates, that reasoning cannot be limited to the specific facts in *DCM;* if a "little usury" that just increases interest to the market rate is exempt, then an additional charge, fee or consideration must be permitted on the same principle. In my view, *DCM* and its logical extension in the majority opinion herein effect serious judicial erosion of the usury law.

As I stated in ****974 ***432** *Boerner v. Colwell Co., supra,* 21 Cal.3d 37, 145 Cal.Rptr. 380, 577 P.2d 200, the people of California have made it emphatically clear that they reject the exaction of usurious rates of interest as an acceptable commercial practice. (*Id.* at p. 54, 145 Cal.Rptr. 380, 577 P.2d 200 (conc. & dis. opn. of Mosk, J.).) In response to the unmistakable legislative intent of the people, courts must be vigilant to pierce the veil of any transaction that in effect results in a loan or forbearance at an interest rate exceeding the legal maximum. I would apply this principle even when a forbearance extends a loan that was originally exempt from the usury law, and even if the parties did not set out to violate the usury law. As we observed in *Burr v. Capital Reserve Corp.* (1969) 71 Cal.2d 983, 989, 80 Cal.Rptr. 345, 458 P.2d 185, "a conscious attempt to evade the usury law is not necessary...."

I would affirm the judgment.

All Citations

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Footnotes

1 The $100,000 fee was not necessarily payable in full. The parties agreed that, "[T]his entire sum of $100,000 shall not be due Beneficiary [Antonioli] if Trustor [Ghirardo] pays off the entire face amount of the note plus accrued interest prior to March 1, 1988. Rather, for each day, beginning with December 2, 1986, one-four hundred and fifty-sixth (1/456th) of the sum of $100,000, or $219.30, and [sic] be added to the principal of the note and interest shall begin to accrue on this new increment to principal."

2 California's usury proscription is also set forth in a statute, an initiative measure that has not been codified. (Stats.1919, p. lxxxiii, Deering's Uncod. Initiative Measures & Stats. (1973 ed.) 1919–1, p. 35].) This statute remains in full force to the extent it does not conflict with the Constitution. (*Penziner v. West American Finance Co.* (1937) 10 Cal.2d 160, 170–178, 74 P.2d 252.) Although the statute states that it may be referred to as the "usury law" (Stats.1919, p. lxxxiii, Deering's Uncod. Initiative Measures & Stats., *supra,* 1919–1, § 5, p. 117), we use the term in its more general sense to refer to both the constitutional and statutory usury provisions.

3 Antonioli also contends usury law should not apply to settlements of litigation. That issue was not raised in the Court of Appeal and, considering our decision in Antonioli's favor on other grounds, we decline to decide this issue.

1 As the majority correctly concede, in determining whether a transaction constitutes a loan or forbearance, courts look to the substance rather than the form. (*Southwest Concrete Products v. Gosh Construction Corp.* (1990) 51 Cal.3d 701, 705, 274 Cal.Rptr. 404, 798 P.2d 1247; *Boerner v. Colwell Co.* (1978) 21 Cal.3d 37, 44, 145 Cal.Rptr. 380, 577 P.2d 200.)

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3 Cal.4th 459
Supreme Court of California,
In Bank.

NEDLLOYD LINES B.V. et al., Petitioners,
v.
The SUPERIOR COURT OF SAN MATEO COUNTY, Respondent;
SEAWINDS LIMITED, Real Party in Interest.

S015917, S019540.
|
Aug. 31, 1992.

Synopsis

Shipping company brought action against shareholders for breach of contract, tortious breach of good faith and fair dealing, and violations of fiduciary duties. The Superior Court, San Mateo County, No. 337705, Thomas M. Jenkins, J., denied shareholders' motion to dismiss and sustained their demurrer. Shareholders petitioned for extraordinary relief. Following the Court of Appeal's summary denial of writ, the Supreme Court granted shareholders' petition for review and transferred case back to Court of Appeal with instructions to issue alternative writ. After complying with Supreme Court's direction, the Court of Appeal, denied shareholders' petition. Shareholders petitioned for review. Meanwhile, the trial court overruled shareholders' demurrer to shipping company's first amended complaint, and shareholders again petitioned for writ, which was summarily denied by the Court of Appeal. Granting review of both orders and consolidating proceedings on both writ matters, superseding opinions of Court of Appeal, the Supreme Court, Baxter, J., held that choice-of-law clause requiring that contract be "governed by" law of Hong Kong was fully enforceable and applicable to claims for breach of implied covenant of good faith and fair dealing and for breach of fiduciary duties allegedly arising out of contract.

Reversed and remanded with instructions.

Panelli, J., filed concurring and dissenting opinion in which Mosk, J., concurred.

Kennard, J., filed concurring and dissenting opinion.

Opinion, 277 Cal.Rptr. 822, superseded.

Attorneys and Law Firms

***461** ****1149** *****331** Walsh, Donovan, Lindh & Keech, Charles S. Donovan, James R. Walsh, Edward M. Keech, Ann S. Crownover and Elizabeth M. Miller, San Francisco, for petitioners.

No appearance for respondent.

***462** Furth, Fahrner & Mason, Thomas R. Fahrner, Michele C. Jackson and Michael R. Hudson, San Francisco, for real party in interest.

Opinion

BAXTER, Associate Justice.

We granted review to consider the effect of a choice-of-law clause in a contract between commercial entities to finance and operate an international shipping business. In our order granting review, we limited our consideration to the question whether and to what extent the law of Hong Kong, chosen in the parties' agreement, should be applied in ruling on defendant's demurrer to plaintiff's complaint.

We conclude the choice-of-law clause, which requires that the contract be "governed by" the law of Hong Kong, a jurisdiction having a substantial connection with the parties, is fully enforceable and applicable to claims for breach of the implied covenant of good faith and fair dealing and for breach of fiduciary duties allegedly arising out of the contract. Our conclusion rests on the choice-of-law rules derived from California decisions and the Restatement Second of Conflict of Laws, which reflect strong policy considerations favoring the enforcement of freely negotiated choice-of-law clauses. Based on our conclusion, we will reverse the judgments of the Court of Appeal and remand for further proceedings.

STATEMENT OF FACTS AND PROCEEDINGS BELOW

Plaintiff and real party in interest Seawinds Limited (Seawinds) is a shipping company, currently undergoing reorganization under chapter 11 of the United States Bankruptcy Code, whose business consists of the operation of three container ships. Seawinds was incorporated in Hong Kong in late 1982 and has its principal place of business in Redwood City, California. Defendants and petitioners Nedlloyd Lines B.V., Royal Nedlloyd Group N.V., and KNSM Lines B.V. (collectively referred to as

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Nedlloyd) are interrelated shipping companies incorporated in the Netherlands with their principal place of business in Rotterdam.

In March 1983, Nedlloyd and other parties (including an Oregon corporation, a Hong Kong corporation, a British corporation, three individual residents of California, and a resident of Singapore) entered into a contract with Seawinds to purchase shares of Seawinds's stock. The contract, which was entitled "Shareholders' Agreement in Respect of Seawinds Limited," stated that its purpose was "to establish [Seawinds] as a joint venture company to carry on a transportation operation." The ****1150 ***332** agreement also provided that Seawinds would carry on the business of the transportation ***463** company and that the parties to the agreement would use "means reasonably available" to ensure the business was a success.

The shareholders' agreement between the parties contained the following choice-of-law and forum selection provision: "This agreement shall be governed by and construed in accordance with Hong Kong law and each party hereby irrevocably submits to the non-exclusive jurisdiction and service of process of the Hong Kong courts."

In January 1989, Seawinds sued Nedlloyd, alleging in essence that Nedlloyd breached express and implied obligations under the shareholders' agreement by: "(1) engaging in activities that led to the cancellation of charter hires that were essential to Seawinds' business; (2) attempting to interfere with a proposed joint service agreement between Seawinds and the East Asiatic Company, and delaying its implementation; (3) making and then reneging on commitments to contribute additional capital, thereby dissuading others from dealing with Seawinds, and (4) making false and disparaging statements about Seawinds' business operations and financial condition." Seawinds's original and first amended complaint included causes of action for breach of contract, breach of the implied covenant of good faith and fair dealing (in both contract and tort), and breach of fiduciary duty. This matter comes before us after trial court rulings on demurrers to Seawinds's complaints.

Nedlloyd demurred to Seawinds's original complaint on the grounds that it failed to state causes of action for breach of the implied covenant of good faith and fair dealing (either in contract or in tort) and breach of fiduciary duty. In support of its demurrer, Nedlloyd contended the shareholders' agreement required the application of Hong Kong law to Seawinds's claims. In opposition to the demurrer, Seawinds argued that California law should be applied to its causes of action.

In ruling on Nedlloyd's demurrer, the trial court expressly determined that California law applied to all of Seawinds's causes of action. It sustained the demurrers with leave to amend as to all causes of action, relying on grounds not pertinent to the issues before us. Nedlloyd sought a writ of mandate from the Court of Appeal directing the application of Hong Kong law. After the Court of Appeal summarily denied Nedlloyd's initial writ petition, we granted Nedlloyd's petition for review and transferred the case back to the Court of Appeal with instructions to issue an alternative writ.

After complying with our direction, the Court of Appeal denied Nedlloyd's first writ petition and discharged the alternative writ. In a published ***464** opinion, the Court of Appeal upheld the application of California law to Seawinds's claims. We granted Nedlloyd's petition for review.

In the meantime, the trial court overruled Nedlloyd's demurrer to Seawinds's first amended complaint, again applying California law to Seawinds's causes of action. The Court of Appeal summarily denied Nedlloyd's second writ petition challenging the order overruling the latter demurrer; we also granted review of that order and consolidated proceedings on the two writ matters so as to preserve the choice-of-law issue for review. As noted above, we have limited review in both proceedings to the choice-of-law issue.

DISCUSSION

I. *The proper test*

We have not previously considered the enforceability of a contractual choice-of-law provision. We have, however, addressed the closely related issue of the enforceability of a contractual choice-of-forum provision, and we have made clear that, "No satisfying reason of public policy has been suggested why enforcement should be denied a forum selection clause appearing in a contract entered into freely and voluntarily by parties who have negotiated at arm's length." (*Smith, Valentino & Smith, Inc. v. Superior Court* (1976) 17 Cal.3d 491, 495–496, 131 Cal.Rptr. 374, 551 P.2d 1206 (*Smith*).) The forum selection provision in ****1151 ***333** *Smith* was contained within a choice-of-law clause, and we observed that, "Such choice of law provisions are usually respected by California courts." (*Id.,* at p. 494, 131 Cal.Rptr. 374, 551 P.2d 1206.) We noted this result was

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consistent with the modern approach of section 187 of the Restatement Second of Conflict of Laws (Restatement). (17 Cal.3d at p. 494, 131 Cal.Rptr. 374, 551 P.2d 1206.) Prior Court of Appeal decisions, although not always explicitly referring to the Restatement, also overwhelmingly reflect the modern, mainstream approach adopted in the Restatement. (*Mencor Enterprises, Inc. v. Hets Equities Corp.* (1987) 190 Cal.App.3d 432, 435–436, 235 Cal.Rptr. 464 [explicit reference to Restatement section 187]; *Hall v. Superior Court* (1983) 150 Cal.App.3d 411, 417, 197 Cal.Rptr. 757 [no explicit reference]; *Ashland Chemical Co. v. Provence* (1982) 129 Cal.App.3d 790, 794–795, 181 Cal.Rptr. 340 [no explicit reference]; *Gamer v. duPont Glore Forgan, Inc.* (1976) 65 Cal.App.3d 280, 287, 135 Cal.Rptr. 230 [explicit reference to Restatement section 187].) [1]

We reaffirm this approach. In determining the enforceability of arm's-length contractual choice-of-law provisions, California courts shall apply the ***465** principles set forth in Restatement section 187, which reflect a strong policy favoring enforcement of such provisions. [2]

More specifically, Restatement section 187, subdivision (2) sets forth the following standards: "The law of the state chosen by the parties to govern their contractual rights and duties will be applied, even if the particular issue is one which the parties could not have resolved by an explicit provision in their agreement directed to that issue, unless either [¶] (a) the chosen state has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties choice, or [¶] (b) application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue and which, under the rule of § 188, would be the state of the applicable law in the absence of an effective choice of law by the parties." [3]

****1152** *****334** ***466** Briefly restated, the proper approach under Restatement section 187, subdivision (2) is for the court first to determine either: (1) whether the chosen state has a substantial relationship to the parties or their transaction, or (2) whether there is any other reasonable basis for the parties' choice of law. If neither of these tests is met, that is the end of the inquiry, and the court need not enforce the parties' choice of law. [4] If, however, either test is met, the court must next determine whether the chosen state's law is contrary to a *fundamental* policy of California. [5] If there is no such conflict, the court shall enforce the parties' choice of law. If, however, there is a fundamental conflict with California law, the court must then determine whether California has a "materially greater interest than the chosen state in the determination of the particular issue...." (Rest., § 187, subd. (2).) If California has a materially greater interest than the chosen state, the choice of law shall not be enforced, for the obvious reason that in such circumstance we will decline to enforce a law contrary to this state's fundamental policy. [6] We now apply the Restatement test to the facts of this case.

***467** II. *Application of the test in this case*

A. *Breach of contract*

Nedlloyd did not assert in its second demurrer that the amended complaint failed to state a cause of action under Hong Kong law for breach of contract. Rather, Nedlloyd challenged the amended complaint's breach of contract allegations only on the ground of uncertainty. (Code Civ.Proc., § 430.10, subd. (f).) In light of our order limiting review to the issue of whether Hong Kong law "should be applied in ruling on the demurrers," we need not and do not consider the correctness of the trial court's ruling on the demurrer to this cause of action. As we shall explain, however, Hong Kong law, although not asserted as a bar to Seawinds's contract cause of action at the pleading stage, does govern all causes of action pleaded in the amended *****335** complaint, including the contract cause of action.

****1153** B. *Implied covenant of good faith and fair dealing*

1. *Substantial relationship or reasonable basis*

As to the first required determination, Hong Kong—"the chosen state"—clearly has a "substantial relationship to the parties." (Rest., § 187, subd. (2)(a).) The shareholders' agreement, which is incorporated by reference in Seawinds' first amended complaint, shows that Seawinds is incorporated under the laws of Hong Kong and has a registered office there. The same is true of one of the shareholder parties to the agreement—Red Coconut Trading Co. The incorporation of these parties in Hong Kong provides the required "substantial relationship." (*Id.,* com. f [substantial relationship present when "one of the parties is domiciled" in the chosen state]; *Carlock v. Pillsbury Co.* (D.Minn.1989) 719 F.Supp. 791, 807 ["A party's incorporation in a state is a contact sufficient to allow the parties to choose that state's law to govern their contract."]; *Hale v. Co–Mar Offshore Corp.* (W.D.La.1984) 588 F.Supp. 1212, 1215 [same effect].)

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Moreover, the presence of two Hong Kong corporations as parties also provides a "reasonable basis" for a contractual provision requiring application of Hong Kong law. "If one of the parties resides in the chosen state, the parties have a reasonable basis for their choice." (*Consul Ltd. v. Solide Enterprises, Inc., supra,* 802 F.2d 1143, 1147.) The reasonableness of choosing Hong Kong becomes manifest when the nature of the agreement before us is considered. A state of incorporation is certainly at least one government entity with a keen and intimate interest in internal corporate affairs, including the purchase and sale of its shares, as well as corporate management and ***468** operations. (See Corp.Code, § 102 [applying California's general corporation law to domestic corporations].)

2. *Existence of fundamental public policy*

We next consider whether application of the law chosen by the parties would be contrary to "a fundamental policy" of California. We perceive no fundamental policy of California requiring the application of California law to Seawinds's claims based on the implied covenant of good faith and fair dealing. The covenant is not a government regulatory policy designed to restrict freedom of contract, but an implied promise inserted in an agreement to carry out the presumed intentions of contracting parties. (*Foley v. Interactive Data Corp.* (1988) 47 Cal.3d 654, 689–690, 254 Cal.Rptr. 211, 765 P.2d 373 (*Foley*) ["When a court enforces the implied covenant it is in essence acting to protect 'the interest in having promises performed' [citation]—the traditional realm of a contract action—rather than to protect some general duty to society which the law places on an employer without regard to the substance of its contractual obligations to its employee."].)

Seawinds directs us to no authority exalting the *implied* covenant of good faith and fair dealing over the *express* covenant of these parties that Hong Kong law shall govern their agreement. We have located none. Because Seawinds has identified no fundamental policy of our state at issue in its essentially contractual dispute with Nedlloyd, the second exception to the rule of section 187 of the Restatement does not apply.

C. *Fiduciary duty cause of action*

1. *Scope of the choice-of-law clause*

Seawinds contends that, whether or not the choice-of-law clause governs Seawinds's implied covenant claim, Seawinds's fiduciary duty claim is somehow independent of the shareholders' agreement and therefore outside the intended scope of the clause. Seawinds thus concludes California law must be applied to this claim. We disagree.

When two sophisticated, commercial entities agree to a choice-of-law clause like the one in this case, the most reasonable interpretation of their actions is that they intended for the clause to apply to all causes of action arising from or related to their contract. Initially, such an interpretation is supported by the plain meaning of ****1154** *****336** the language used by the parties. The choice-of-law clause in the shareholders' agreement provides: "This agreement shall be *governed by* and construed in accordance with ***469** Hong Kong law and each party hereby irrevocably submits to the non-exclusive jurisdiction and service of process of the Hong Kong courts." (Italics added.) [7]

The phrase "governed by" is a broad one signifying a relationship of absolute direction, control, and restraint. Thus, the clause reflects the parties' clear contemplation that "the agreement" is to be completely and absolutely controlled by Hong Kong law. No exceptions are provided. In the context of this case, the agreement to be controlled by Hong Kong law is a shareholders' agreement that expressly provides for the purchase of shares in Seawinds by Nedlloyd and creates the relationship between shareholder and corporation that gives rise to Seawinds's cause of action. Nedlloyd's fiduciary duties, if any, arise from—and can exist only because of—the shareholders' agreement pursuant to which Seawinds's stock was purchased by Nedlloyd.

In order to control completely the agreement of the parties, Hong Kong law must also govern the stock purchase portion of that agreement and the legal duties created by or emanating from the stock purchase, including any fiduciary duties. If Hong Kong law were not applied to these duties, it would effectively control only part of the agreement, not all of it. Such an interpretation would be inconsistent with the unrestricted character of the choice-of-law clause.

Our conclusion in this regard comports with common sense and commercial reality. When a rational businessperson enters into an agreement establishing a transaction or relationship and provides that disputes arising from the agreement shall be governed by the law of an identified jurisdiction, the logical conclusion is that he or she intended

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that law to apply to *all* disputes arising out of the transaction or relationship. We seriously doubt that any rational businessperson, attempting to provide by contract for an efficient and businesslike resolution of possible future disputes, would intend that the laws of multiple jurisdictions would apply to a single controversy having its origin in a single, contract-based relationship. Nor do we believe such a ***470** person would reasonably desire a protracted litigation battle concerning only the threshold question of what law was to be applied to which asserted claims or issues. Indeed, the manifest purpose of a choice-of-law clause is precisely to avoid such a battle.

Seawinds's view of the problem—which would require extensive litigation of the parties' supposed intentions regarding the choice-of-law clause to the end that the laws of multiple states might be applied to their dispute—is more likely the product of postdispute litigation strategy, not predispute contractual intent. If commercially sophisticated parties (such as those now before us) truly intend the result advocated by Seawinds, they should, in fairness to one another and in the interest of economy in dispute resolution, negotiate and obtain the assent of their fellow parties to explicit contract language specifying what jurisdiction's law applies to what issues.

Justice Mosk long ago cogently observed that, "Given two experienced businessmen dealing at arm's length, both represented by competent counsel, it has become virtually ****1155** *****337** impossible under recently evolving rules of evidence to draft a written contract that will produce predictable results in court. The written word, heretofore deemed immutable, is now at all times subject to alteration by self-serving recitals based upon fading memories of antecedent events. This, I submit, is a serious impediment to the certainty required in commercial transactions." (*Delta Dynamics, Inc. v. Arioto* (1968) 69 Cal.2d 525, 532, 72 Cal.Rptr. 785, 446 P.2d 785 (dis. opn. of Mosk, J.).)

With due acknowledgment of Justice Mosk's prescience, other courts have more recently reiterated that, "While [the] rule [of easily pleaded ambiguity] creates much business for lawyers and an occasional windfall to some clients, it leads only to frustration and delay for most litigants and clogs already overburdened courts." (*Trident Center v. Connecticut General Life Ins.* (9th Cir.1988) 847 F.2d 564, 569; *Wilson Arlington Co. v. Prudential Ins. Co.* (9th Cir.1990) 912 F.2d 366, 370.) We need not envelop choice-of-law clauses in this fog of uncertainty and ambiguity.

For the reasons stated above, we hold a valid choice-of-law clause, which provides that a specified body of law "governs" the "agreement" between the parties, encompasses all causes of action arising from or related to that agreement, regardless of how they are characterized, including tortious breaches of duties emanating from the agreement or the legal relationships it creates.

2. *Enforceability of chosen law as to fiduciary duty claim*

Applying the test we have adopted (see pt. I, *ante,* at pp. 332–334 of 11 Cal.Rptr.2d, pp. 1150–1152 of 834 P.2d.), we find no reason not to apply the parties' choice of law to Seawinds's cause of ***471** action for breach of fiduciary duty. As we have explained, Hong Kong, the chosen state, has a "substantial relationship to the parties" because two of those parties are incorporated there. Moreover, their incorporation in that state affords a "reasonable basis" for choosing Hong Kong law. (See pt. II.B.1., *ante,* at pp. 334–335 of 11 Cal.Rptr.2d, pp. 1152–1153 of 834 P.2d.)

Seawinds identifies no fundamental public policy of this state that would be offended by application of Hong Kong law to a claim by a Hong Kong corporation against its allegedly controlling shareholder. We are directed to no California statute or constitutional provision designed to preclude freedom of contract in this context. Indeed, even in the absence of a choice-of-law clause, Hong Kong's overriding interest in the internal affairs of corporations domiciled there would in most cases require application of its law. (See Rest., § 306 [obligations owed by majority shareholder to corporation determined by the law of the state of incorporation except in unusual circumstances not present here]; *McDermott Inc. v. Lewis* (Del.Super.Ct.1987) 531 A.2d 206, 214–216 [corporate voting rights dispute governed by law of state of incorporation]; *Matter of Reading Co.* (3d Cir.1983) 711 F.2d 509, 517 [minority shareholder fiduciary duty claim governed by law of state of incorporation].)

For strategic reasons related to its current dispute with Nedlloyd, Seawinds seeks to create a fiduciary relationship by disregarding the law Seawinds voluntarily agreed to accept as binding—the law of a state that also happens to be Seawinds's own corporate domicile. To allow Seawinds to use California law in this fashion would further no ascertainable fundamental policy of California; indeed, it would undermine California's policy of respecting the choices made by parties to voluntarily negotiated agreements.

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DISPOSITION

By a choice-of-law clause in a fully negotiated commercial contract, the parties have chosen Hong Kong law to apply to their dispute in this case, including each of the causes of action asserted by Seawinds.

Seawinds's action is now proceeding based on its first amended complaint, which will be the focus of further proceedings applying Hong Kong law to resolve the parties' differences. Therefore, the judgments ***338 of **1156 the Court of Appeal in the consolidated proceedings (Court of Appeal Nos. A049718 and A050535) are reversed, and the matters are remanded to the Court of Appeal with instructions to issue a peremptory writ of mandate directing the trial *472 court to reconsider its ruling on Nedlloyd's demurrer to Seawinds' first amended complaint in light of applicable Hong Kong law.

LUCAS, C.J., and ARABIAN and GEORGE, JJ., concur.

PANELLI, Associate Justice, concurring and dissenting.
I generally concur in the majority opinion's explanation of the standards controlling when a contractual choice-of-law provision will be honored by the courts of this state and with the majority's application of these standards to Seawinds's cause of action for breach of the covenant of good faith and fair dealing. I write separately to express my disagreement with the majority's conclusion, based on the record before us, that the choice-of-law clause in this case governs Seawinds's cause of action for breach of fiduciary duty. In my view, the majority's analysis of the scope of the choice-of-law clause is unsound.

The choice-of-law clause in this case reads in pertinent part: "This agreement shall be governed by and construed in accordance with Hong Kong law...." [1] The majority determines that the scope of the choice-of-law clause, which was incorporated into the first amended complaint by attachment, extends to related, *noncontractual* causes of action, such as Seawinds's breach of fiduciary duty claim. In so doing, the majority opinion adopts the rule that "[w]hen two sophisticated, commercial entities agree to a choice-of-law clause like the one in this case, the most reasonable interpretation of their actions is that they intended for the clause to apply to all causes of action arising from or related to their contract." (Maj. opn., *ante,* at p. 335 of 11 Cal.Rptr.2d, p. 1153 of 834 P.2d.) Without citing any authority, the majority opinion announces a binding rule of contractual interpretation, based solely upon "common sense and commercial reality." (*Id.* at p. 336 of 11 Cal.Rptr.2d, p. 1154 of 834 P.2d.)

The problem with the majority's approach is that it ignores controlling California law. On demurrer, a pleading must be liberally construed. (Code Civ.Proc., § 452.) The accepted rule of contractual construction on demurrer is that "[w]here a written contract is pleaded by attachment to and incorporation in a complaint, and where the complaint fails to allege that the terms of the contract have any special meaning, a court will construe the language of the contract on its face to determine whether, as a matter of law, the contract is reasonably subject to a construction sufficient to sustain a cause of action...." (*Hillsman v. Sutter Community Hospitals* (1984) 153 Cal.App.3d 743, 749–750, 200 Cal.Rptr. 605; accord *Beck v. American* *473 *Health Group Internat., Inc.* (1989) 211 Cal.App.3d 1555, 1561, 260 Cal.Rptr. 237.) In this case, the language of the incorporated contract easily can be read to apply only to contractual causes of action: "*This agreement* shall be governed ... by Hong Kong law."

In my view, the majority's mistaken construction of the choice-of-law clause is clear when the language used in the present contract is compared, as Nedlloyd urges us to do, with the language construed by this court in *Smith, Valentino & Smith, Inc. v. Superior Court* (1976) 17 Cal.3d 491, 131 Cal.Rptr. 374, 551 P.2d 1206. In that case, this court determined that claims for unfair competition and intentional interference with advantageous business relationships were governed by a choice-of-forum clause as " 'actions or proceedings instituted by ... [Smith] under this Agreement with respect **1157 ***339 to any matters arising under *or growing out of this agreement* ....' " (*Id.* at p. 497, 131 Cal.Rptr. 374, 551 P.2d 1206, emphasis in the original.) In contrast to the language used by Nedlloyd and Seawinds in their agreement, the contractual language, "arising under or growing out of this agreement," which was used in *Smith,* explicitly shows an intent to embrace related noncontractual claims, as well as contractual claims. Although similar language was readily available to them, the sophisticated parties in the present case did not draft their choice-of-law clause to clearly encompass related noncontractual causes of action. [2] Therefore, on demurrer and in the absence of parol evidence, I cannot fairly construe the contractual language at issue here to be consistent with the interpretation proposed by

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Nedlloyd and adopted in the majority opinion. To do so would violate the statutory canon of contract interpretation that "[t]he language of a contract is to govern its interpretation, if the language is clear and explicit, and does not involve an absurdity." (Civ.Code, § 1638.)

Finally, the majority's rule effectively subordinates the intent of the contracting parties to the need for predictability in commercial transactions. The majority strikes this balance despite the fact that our Legislature has commanded otherwise. Under California law, "[a] contract must be so interpreted as to give effect to the mutual intention of the parties as it existed at the time of contracting, so far as the same is ascertainable and lawful." (Civ.Code, § 1636.) In contrast to this legislative command, the majority conclusively presumes that choice-of-law clauses entered into between or among commercial entities apply to related noncontractual causes of action regardless of whether the intent of the parties or the contract language (as in this case) shows otherwise. I believe that the departure by the majority from ***474** established California law is unwarranted and is unnecessary to further the goals of predictability in the enforcement of contracts and protection of the justified expectations of contracting parties. These goals can be adequately protected within the framework of the current law governing contractual interpretation by enforcing choice-of-law clauses in a manner consistent with the language of the contract and the intent of the parties.

I am keenly aware of the need for predictability in the enforcement of commercial contracts. Nevertheless, although courts and litigants may wish the law were otherwise, not every issue can be conclusively determined at the pleading stage. On the present record, the scope of the choice-of-law clause must be construed in favor of Seawinds.

MOSK, J., concurs.

KENNARD, Associate Justice, concurring and dissenting.
Fueled by advances in technology, communications and global cooperation, trade across state and international borders is vastly greater than in decades past. California occupies a leading position in the field of international trade, and this leadership is of vital importance to the welfare of the state and its residents. As commerce across borders expands, novel legal problems arise, and familiar issues assume renewed significance.

This case involves the effect of a choice-of-law clause in a contract between multinational parties to conduct an international shipping business. I agree with the majority that the parties' agreement, calling for the contract to be interpreted according to Hong Kong law, should be applied by the California courts in determining whether plaintiff, a Hong Kong corporation, has stated a cause of action for breach of the implied covenant of good faith and fair dealing. I disagree, however, with the majority's conclusion that the choice-of-law clause, which provides only that the contract ****1158** *****340** shall be governed by Hong Kong law, unambiguously extends to related noncontractual causes of action and therefore should be applied by the trial court in determining whether the plaintiff has stated a cause of action for breach of fiduciary duty.

I. BACKGROUND

Defendants and petitioners Nedlloyd Lines B.V., Royal Nedlloyd Group N.V., and KNSM Lines B.V. (hereafter collectively Nedlloyd) are interrelated shipping companies based in Rotterdam, the Netherlands. Plaintiff and real party in interest Seawinds Limited (hereafter Seawinds) is a shipping company that was incorporated in Hong Kong in late 1982, with its principal place of business in Redwood City, California.

***475** In 1983, Nedlloyd Lines B.V. entered into a contract to purchase shares in Seawinds. The other parties to the contract were an Oregon corporation, a Hong Kong corporation, a British corporation, three individual residents of California, a resident of Singapore, and Seawinds itself. [1] The agreement's stated purpose was "to establish [Seawinds] as a joint venture company to carry on a transportation operation." The contract contained this choice-of-law provision: "This agreement shall be governed by and construed in accordance with Hong Kong law and each party hereby irrevocably submits to the non-exclusive jurisdiction and service of process of the Hong Kong courts."

Seawinds engaged in the shipping business from April 1983 until October 1984, when it commenced bankruptcy proceedings that are apparently still pending in federal court.

In January 1989, Seawinds sued Nedlloyd, [2] alleging that Nedlloyd had detrimentally interfered with its business, reneged on promises to make capital contributions, and falsely disparaged its operation. The original complaint set

forth three causes of action: (1) "Breach of Contract; Breach of Implied Covenant of Good Faith and Fair Dealing"; (2) "Tortious Breach of Implied Covenant of Good Faith and Fair Dealing"; and (3) "Violation of Fiduciary Duties."

Nedlloyd demurred to the complaint on the ground that under Hong Kong law the complaint failed to state a cause of action for breach of the implied covenant, tortious breach of the implied covenant, and breach of fiduciary duties. Nedlloyd also demurred to the second cause of action on the ground that "many of the necessary elements of tortious breach of contract are not pled." With respect to the third cause of action, Nedlloyd demurred on the basis that the complaint failed to allege that Nedlloyd was a majority shareholder, and that, "[i]n addition, if Hong Kong law applies, any fiduciary duties of majority shareholders run only to other shareholders, not to the corporation itself."

The trial court ruled broadly that "California law shall apply in this case." But the court sustained Nedlloyd's demurrer with leave to amend as to all three causes of action, ruling that: (1) the first cause of action should be split into two causes of action; (2) the second cause of action had not alleged a sufficient special relationship; and (3) "no controlling interest sufficient to ***476** establish a fiduciary relationship" had been alleged in the third cause of action.

Nedlloyd petitioned the Court of Appeal for a writ of mandate to overturn the trial court's choice-of-law ruling. The Court of Appeal denied the writ petition.[3] It held that the trial court had properly decided to apply California law because Hong Kong, the state whose law was chosen by the parties, had no substantial relationship ****1159 ***341** with the parties or their claims, and because enforcement of the choice-of-law clause would "ero [de] a California law protective of its citizens' rights" in that "Hong Kong law does not recognize the concept of an implied covenant of good faith and fair dealing in contracts whereas California implies such a covenant in every contract." The Court of Appeal also concluded: "Under Hong Kong law, shareholders seemingly owe no fiduciary duties to the company; instead, a majority shareholder might owe a fiduciary duty to another shareholder. In contrast, California law imposes a fiduciary duty on a majority of shareholders or a controlling shareholder to the minority shareholders and the company." This court granted Nedlloyd's petition for review.

Meanwhile, in the trial court, Seawinds had filed an amended complaint, alleging causes of action for: (1) "Breach of Contract"; (2) "Breach of Implied Covenant of Good Faith and Fair Dealing"; and (3) "Violations of Fiduciary Duties." Nedlloyd demurred to the amended complaint on four grounds: (1) the breach of contract cause of action was uncertain; (2) the breach of implied covenant cause of action failed under Hong Kong law; (3) the breach of implied covenant cause of action failed "because the necessary elements of such breach are not pled"; and (4) the cause of action for breach of fiduciary duty "fails to allege any duty or breach."

The trial court overruled the demurrer to the amended complaint, and Nedlloyd once again petitioned the Court of Appeal for a writ of mandate. Upon the Court of Appeal's denial of this second writ application (contemporaneous with its opinion on the first petition), this court granted Nedlloyd's separate petition for review and consolidated it with the related proceeding.

As will be explained, in substance two distinct issues are before us: (1) whether the choice-of-law clause requires the application of Hong Kong law to the implied covenant cause of action; and (2) whether the choice-of-law clause requires the application of Hong Kong law to the breach of fiduciary duty cause of action. I will discuss each issue separately.

***477** II. BREACH OF THE IMPLIED COVENANT

A. *Existence of a Conflict*

The first step in the analysis of an asserted conflict of laws is to determine whether a choice of law by the court is actually required. In the context of a contractual choice-of-law clause, a conflict is presented only if there is a material difference between the law of the chosen state and the law of the state whose law would apply in the absence of an effective choice by the parties. In this case, the parties agree that if Hong Kong law does not apply, the law of California does.

In its original complaint, Seawinds pleaded two theories of liability—breach of contract and breach of the implied covenant of good faith and fair dealing—as part of the same cause of action. In the amended complaint, Seawinds separated these theories, pleading each as a cause of action. I analyze them separately.

In its demurrer to the amended complaint, Nedlloyd did not assert that the amended complaint failed to state a cause

of action for breach of contract under Hong Kong law. Rather, Nedlloyd challenged the amended complaint's breach of contract allegations only on the ground of uncertainty (Code Civ.Proc., § 430.10, subd. (f)). Thus, the breach of contract cause of action presents no choice-of-law issue at this time.

Seawinds' second theory of liability in the amended complaint is breach of the implied covenant of good faith and fair dealing. In its demurrer, Nedlloyd asserted that this theory of liability fails because Hong Kong law governs the contract and, unlike California law, does not recognize an implied covenant of good faith and fair dealing. Accordingly, this theory of liability does present a choice-of-law issue, but only if, as Nedlloyd asserts, there is a material difference between the relevant law of Hong Kong and California. (See ****1160** *****342** *Hurtado v. Superior Court* (1974) 11 Cal.3d 574, 580, 114 Cal.Rptr. 106, 522 P.2d 666; *Bos Material Handling, Inc. v. Crown Controls Corp.* (1982) 137 Cal.App.3d 99, 105, 186 Cal.Rptr. 740; *New Linen Supply v. Eastern Environmental Controls, Inc.* (1979) 96 Cal.App.3d 810, 817, fn. 2, 158 Cal.Rptr. 251.)

Under California law, every contract contains an implied covenant of good faith and fair dealing. (*Foley v. Interactive Data Corp.* (1988) 47 Cal.3d 654, 683, 254 Cal.Rptr. 211, 765 P.2d 373.) This implied covenant requires "that neither party do anything which will deprive the other of the benefits of the agreement" ***478** (*Seaman's Direct Buying Service, Inc. v. Standard Oil Co.* (1984) 36 Cal.3d 752, 768, 206 Cal.Rptr. 354, 686 P.2d 1158), and its breach ordinarily gives rise to contract remedies (*ibid.*).

The parties presented evidence of the relevant Hong Kong law.[4] In support of its demurrer, Nedlloyd submitted the declaration of William Catley, a Hong Kong solicitor. Based on his review of the case law, Catley stated in his declaration that Hong Kong courts will not imply a covenant into a contract unless "it is necessary either to give effect to the intentions of the parties or to give the contract business efficacy." Noting that in this case the shareholders' agreement contained a clause requiring the shareholders to cooperate in good faith, but that Seawinds was not a shareholder, Catley set forth his view that it was "unlikely that a court in Hong Kong would imply a term in the [shareholders' agreement] extending this sub-clause to include Seawinds."[5]

In response to Catley's declaration, Seawinds submitted the declaration of another Hong Kong solicitor, Geoffrey Miles. According to Miles, "the Hong Kong courts could well take the view that in order to secure the success of the venture it would be necessary, as a matter of business efficacy, to imply such a term" extending to Seawinds the good faith duties owed to the shareholders.

If Hong Kong law governs the contract, as Nedlloyd contends, Seawinds must show that business efficacy, as Hong Kong courts understand that concept, requires that a good faith term applicable to Seawinds be implied into the contract. But if California law governs the contract, as Seawinds contends, the contract must be deemed to include an implied covenant of good faith and fair dealing. Thus, there appears to be a material difference between Hong Kong and California law, necessitating a choice-of-law analysis.

***479** B. *Choice-of-law Standards*

Although this court has not directly addressed the enforceability of a choice-of-law provision in a contract, the issue has been the subject of a number of appellate court decisions. When a contract specifies the parties' choice of law, California courts have enforced the contractual choice-of-law clause, subject to two qualifications. First, the chosen state must bear some substantial relationship to the parties or the contract, or there must be some other reasonable basis for the parties' choice. Second, application of the chosen state's law must not violate a strong policy of California law. These standards have been adopted, with some variations in language and emphasis, by the overwhelming majority of ****1161** *****343** California decisions. (See *Mencor Enterprises, Inc. v. Hets Equities Corp.* (1987) 190 Cal.App.3d 432, 435–436, 235 Cal.Rptr. 464 [strong policy and substantial relationship]; *Hall v. Superior Court* (1983) 150 Cal.App.3d 411, 417, 197 Cal.Rptr. 757 [strong policy]; *Ashland Chemical Co. v. Provence* (1982) 129 Cal.App.3d 790, 794, 181 Cal.Rptr. 340 [strong policy and substantial relationship]; *Bos Material Handling, Inc. v. Crown Controls Corp., supra,* 137 Cal.App.3d 99, 108, 186 Cal.Rptr. 740 [substantial relationship]; *Gamer v. duPont Glore Forgan, Inc.* (1976) 65 Cal.App.3d 280, 287, 135 Cal.Rptr. 230 [strong policy and substantial relationship]; *Frame v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* (1971) 20 Cal.App.3d 668, 673, 97 Cal.Rptr. 811 [strong policy and substantial relationship]; *Ury v. Jewelers Acceptance Corp.* (1964) 227 Cal.App.2d 11, 18, 20, 38 Cal.Rptr. 376 [strong policy].) The federal appellate courts, in applying California conflicts law, have also adhered to these rules. (*Consul Ltd. v. Solide Enterprises, Inc.* (9th Cir.1986) 802 F.2d 1143, 1146–1147 [strong policy

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and substantial relationship]; *S.A. Empresa, etc. v. Boeing Co.* (9th Cir.1981) 641 F.2d 746, 749 [same]; *Sarlot–Kantarjian v. First Pa. Mortg. Trust* (9th Cir.1979) 599 F.2d 915, 917 [same]; *Foreman v. George Foreman Associates, Ltd.* (9th Cir.1975) 517 F.2d 354, 357 [strong policy].)

The "substantial relationship" and "strong policy" standards of California law are similar to the approach of the Restatement Second of Conflict of Laws, section 187, subdivision (2). [6] Although some California courts have ***480** referred to this part of the Restatement Second with approval, they have never expressly adopted it. [7]

****1162** *****344** As noted above, this court has not previously and directly determined the enforceability of a choice-of-law clause in a contract. The court has, however, considered the related problem of contractual forum selection clauses. In *Smith, Valentino & Smith, Inc. v. Superior Court* (1976) 17 Cal.3d 491, 496, 131 Cal.Rptr. 374, 551 P.2d 1206, the court held that forum selection clauses are valid and may be given effect in the court's discretion and in the absence of a showing that enforcement of the clause would be unreasonable. Citing section 187 of the Restatement Second of Conflict of Laws, the court observed in passing that "choice of law provisions are usually respected by California courts." (17 Cal.3d at p. 494, 131 Cal.Rptr. 374, 551 P.2d 1206.) In following the general approach ***481** of the Restatement Second, California courts are within the jurisprudential mainstream. [8]

In providing that the parties' choice of a state's law to govern a contract will be respected unless either the parties or the contract have no substantial relationship to the chosen state and the parties have no other reasonable basis for the choice, or application of the chosen law would violate a strong policy of the state of the law that would otherwise apply, California choice-of-law analysis reconciles differing and important interests that are in tension in many cases. The first of these interests is party autonomy.

"Party autonomy means that the parties to a contract are free to select the law that governs the contract." (Scoles & Hay, Conflict of Laws (2d ed. 1992) § 18.1, p. 657.) A basic principle of contract law is that contracts should be interpreted to give effect to the intentions of the parties (Civ.Code, § 1636), and the concept of party autonomy implements that principle in the context of choice-of-law clauses.

But to allow parties a completely unrestrained choice of the law they wish to apply to a contract would have unacceptable results. It would license parties to a contract to evade at will the law of the state in which they reside and conduct their activities; they could make contracts, enforceable in their state of residence, that had no substantial connection to the state of the chosen law and that violated the law of the state that would otherwise apply in the absence of a choice-of-law clause. In other words, to allow unrestricted party autonomy in the selection of the governing law would lead to a state's loss of control over the law of contracts and over the activities governed by that law.

Thus, contractual choice-of-law analysis recognizes both the parties' interest in autonomy and the interest of a state in applying its own law to contracts that have a substantial connection to that state. Accordingly, California cases recognize that the ability of parties to select the law that governs a contract should be limited to situations in which the state of the chosen law ***482** has some substantial connection to the parties or the transaction, or to situations in which the parties have some other reasonable basis for their choice, and in which enforcement of the chosen law will not defeat an important policy of the law of the state that would otherwise apply. (See, e.g., *Ashland Chemical Co. v. Provence, supra,* 129 Cal.App.3d at p. 794, 181 Cal.Rptr. 340; *Gamer v. duPont Glore Forgan, Inc., supra,* 65 Cal.App.3d at pp. 287–289, 135 Cal.Rptr. 230.)

****1163** *****345** Application of these standards to this case demonstrates that the parties' choice of Hong Kong law governs Seawinds' cause of action for breach of the implied covenant of good faith and fair dealing. As I shall explain, enforcement of the choice-of-law clause here is appropriate because Hong Kong has a substantial connection to the parties and enforcement of the clause will not defeat an important policy of the law of California, the state whose law would otherwise apply.

C. *Substantial Relationship*

As noted above, the purpose of requiring that the parties or the contract have some substantial relationship to the chosen state is to assure that the parties have not selected the chosen state's law to avoid the application of the law of a particular state to their transaction by stipulating to the law of a state that has no interest in having its law applied. (See *Seeman v. Phila. Warehouse Co.* (1927) 274 U.S. 403, 408, 47 S.Ct. 626, 627, 71 L.Ed. 1123; *Mencor Enterprises,*

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Inc. v. Hets Equities Corp., supra, 190 Cal.App.3d at p. 437, 235 Cal.Rptr. 464; see generally *Woods–Tucker Leasing Corp., etc. v. Hutcheson–Ingram* (5th Cir.1981) 642 F.2d 744, 750–751.) The "substantial relationship" requirement guards against purposeful evasion of a state's laws. [9]

In this case, the "substantial relationship" requirement is satisfied. The shareholders' agreement, which is incorporated as a part of Seawinds's amended complaint, shows that Seawinds itself is incorporated under the laws of Hong Kong and has a registered office there. Moreover, one of the nine shareholders that is a party to the agreement (Red Coconut Trading Co.) ***483** also is incorporated under the laws of Hong Kong and has a registered office there. "If one of the parties resides in the chosen state, the parties have a reasonable basis for their choice." (*Consul Ltd. v. Solide Enterprises, Inc., supra,* 802 F.2d at p. 1147.)

Seawinds contends, however, that the parties and the contract subject matter have contacts with California that are far more extensive than those with Hong Kong. In its amended complaint, Seawinds alleged that its principal place of business was in Redwood City, California; that Nedlloyd "transacted a substantial amount of business" in California; and that Nedlloyd committed in California the acts alleged in the complaint. [10] But when, as here, the parties have chosen the law of a particular state to apply to their contract, the test is not whether another state has a more significant or substantial connection to the parties or the transaction; rather, the test is whether there is a substantial connection with the chosen state. (See *Gamer v. duPont Glore Forgan, Inc., supra,* 65 Cal.App.3d at pp. 288–289, 135 Cal.Rptr. 230.) In this case, there is.

Once a court has concluded that the parties or the transaction have a substantial connection to the chosen state or there is some other reasonable basis for the parties' choice, the next step in analysis of a contractual choice-of-law provision is to determine whether enforcement of the provision will defeat an important policy of the state ****1164** *****346** whose law would apply in the absence of a choice by the parties.

D. *Nature and Strength of State's Interest*

As I have explained, California's rule that application of the chosen law must not violate a strong policy of the state whose law would otherwise apply is similar to the Restatement Second of Conflict of Laws' "fundamental policy" rule. That rule provides that the law of the state chosen by the parties will be applied unless "application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue and which, under the rule of [section] 188, would be the state of the applicable law in the absence of an effective choice of law by the parties." (Rest.2d Conf. of Laws, § 187, subd. (1)(b).) Under section 188 of the Restatement Second, the state of the applicable law is the state that has "the most significant relationship to the transaction and the parties...." (Rest.2d Conf. of Laws, § 188, subd. (1).)

***484** In this case, the parties agree that in the absence of a choice-of-law clause, California law would apply. I assume for argument's sake that this is correct. Under the Restatement Second of Conflict of Laws, then, the task is to decide whether California's interest in determining the particular issue is materially greater than Hong Kong's interest and, if so, whether application of Hong Kong's law would be contrary to a fundamental policy of California. Because, as I explain below, California's interest in enforcing its substantive law is not materially greater than Hong Kong's, I need not reach the fundamental policy issue.

I first assess the nature and strength of California's interest in applying its substantive law to the transaction at issue here. California's interests, however, are not confined to those expressed in its substantive contract rules. As I mentioned earlier, California also has a significant interest in respecting and promoting party autonomy in matters affecting the interpretation and enforcement of contracts. When the parties have by contractual stipulation chosen to have their agreement governed by a law other than California's, our state's separate interests in enforcing its substantive law and in respecting party autonomy are placed in competition with each other. Therefore, to determine California's actual interest in applying its law to override the parties' choice-of-law agreement, I analyze both of the relevant California interests, and then weigh the one against the other.

First, I assess the strength of the state's interest in enforcing the legal rule at issue in this particular case. As mentioned earlier, California law deems every contract to contain an implied-in-law duty of good faith and fair dealing. Our state's law has long recognized this obligation (see, e.g., *Universal Sales Corp. v. Cal. etc. Mfg. Co.* (1942) 20 Cal.2d 751, 771, 128 P.2d 665); it has also been adopted by the Restatement Second of Contracts (Rest.2d Contracts, § 205) and by the majority of American jurisdictions (see *Foley v. Interactive*

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Data Corp., supra, 47 Cal.3d 654, 683, 254 Cal.Rptr. 211, 765 P.2d 373 [hereafter *Foley*]). California courts have enforced the implied covenant of good faith and fair dealing in a variety of circumstances, including insurance contracts, employment contracts, contracts to sell real property, and ordinary commercial contracts. This court observed in *Foley:* "Initially, the concept of a duty of good faith developed in contract law as 'a kind of "safety valve" to which judges may turn to fill gaps and qualify or limit rights and duties otherwise arising under rules of law and specific contract language.' [Citations.]" (*Id.* at p. 684, 254 Cal.Rptr. 211, 765 P.2d 373.)

This court has also recognized, however, that breach of the implied covenant has legal significance that varies with the context of the contract. For example, this court has held that breach of the covenant of good faith by ***485** an insurer gives rise to tort remedies, which may include punitive damages. (*Egan v. Mutual of Omaha Ins. Co.* (1979) 24 Cal.3d 809, 818–819, 169 Cal.Rptr. 691, 620 P.2d 141 (hereafter *Egan*).) On the other hand, we have declined to ****1165 ***347** extend tort remedies for breach of the implied covenant to breaches of employment contracts. (*Foley, supra,* 47 Cal.3d 654, 254 Cal.Rptr. 211, 765 P.2d 373.)

In *Egan,* the court emphasized the "inherently unbalanced" relationship of insurer and insured, and observed that the "adhesive nature of insurance contracts places the insurer in a superior bargaining position." (*Egan, supra,* 24 Cal.3d at p. 820, 169 Cal.Rptr. 691, 620 P.2d 141.) The court pointed out that insurers are purveyors of a vital, quasi-public service, and that insureds do not seek to obtain commercial advantage but protection against calamity. (*Id.* at pp. 819–820, 169 Cal.Rptr. 691, 620 P.2d 141.) The court also observed that " '[i]nsurers hold themselves out as fiduciaries, and with the public's trust must go private responsibility consonant with that trust.' " (*Id.* at p. 820, 169 Cal.Rptr. 691, 620 P.2d 141.)

By contrast, in *Foley* the court reasoned that there were "significant differences" between employer-employee relationships and insurer-insured relationships that justified allowing tort remedies in the one context but not the other. (*Foley, supra,* 47 Cal.3d at p. 689, 254 Cal.Rptr. 211, 765 P.2d 373.) The court recognized, among other considerations, that "the role of the employer differs from that of the 'quasi-public' insurance company" because the employer "is not providing a public service." (*Id.* at p. 692, 254 Cal.Rptr. 211, 765 P.2d 373.) The court stressed that, as compared to the insurance situation, the interests of employer and employee are "most frequently in alignment," and thus "the need to place [additional] disincentives on an employer's conduct ... simply does not rise to the same level as that created by the conflicting interests at stake in the insurance context." (*Id.* at p. 693, 254 Cal.Rptr. 211, 765 P.2d 373.) And the court underscored that "predictability of the consequences of actions related to employment contracts is important to commercial stability." (*Id.* at p. 696, 254 Cal.Rptr. 211, 765 P.2d 373.)

These distinctions indicate that although the state has an interest in enforcing the implied covenant of good faith and fair dealing in every contract, the state's interest is stronger when the covenant acts to protect weaker parties in an inherently unbalanced relationship—typically a relationship in which one party enjoys a superior bargaining position so that it is able to dictate the terms of the agreement—and the weaker party seeks not profit but an essential service. Conversely, the state's interest in enforcing the implied covenant is less compelling when the parties are sophisticated business entities of apparently equal bargaining power that have struck a bargain that is tailored to their particular needs, evidently negotiated and drafted by experienced counsel, and made for no motive other than profit.

This case concerns a contract between multiple sophisticated business entities engaged in transoceanic shipping; the shareholders' agreement is not ***486** a standard form contract, but on its face is drawn to meet the particular needs of the parties, who contemplated large-scale capital investment; commercial advantage was the entire motive behind the contract; and Seawinds seeks damages of $50 million in lost profits for the alleged breaches of the contract's express terms and the implied covenant. Under these circumstances, I have no difficulty concluding, even at the pleading stage, that California's interest in enforcing the implied covenant of good faith and fair dealing is considerably less compelling here than in those contexts in which the covenant acts to protect parties with little bargaining power who seek advantages other than profit.

But this does not end the inquiry into California's interest. There is another interest of California that is implicated: respecting and enforcing party autonomy.

As I have shown, the value served by enforcing a choice-of-law provision is that of party autonomy. Party autonomy itself serves the important and closely related goals of protecting the parties' justified expectations, and promoting

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predictability. Generally, these goals are important in every type of contract. But they are not of equivalent importance in every type of contract. Predictability has special importance ****1166** *****348** in the commercial context. This court observed in *Foley:* "[P]redictability about the cost of contractual relationships plays an important role in our commercial system." (*Foley, supra,* 47 Cal.3d at p. 683, 254 Cal.Rptr. 211, 765 P.2d 373.)

Nedlloyd argues that the needs for predictability and protection of the justified expectations of the parties possess even greater force in the international business context. The United States Supreme Court has endorsed this position in a closely related context, stating that a choice-of-forum provision is "an almost indispensable precondition to achievement of the orderliness and predictability essential to any international business transaction." (*Scherk v. Alberto–Culver Co.* (1974) 417 U.S. 506, 516, 94 S.Ct. 2449, 2455, 41 L.Ed.2d 270; accord *The Bremen v. Zapata Off–Shore Co.* (1972) 407 U.S. 1, 9, 15–16, 92 S.Ct. 1907, 1912, 1916, 32 L.Ed.2d 513.) As the high court has observed: "The expansion of American business and industry will hardly be encouraged if, notwithstanding solemn contracts, we insist on a parochial concept that all disputes must be resolved under our laws and in our courts.... We cannot have trade and commerce in world markets and international waters exclusively on our terms...." (*The Bremen v. Zapata Off–Shore Co., supra,* 407 U.S. at p. 9, 92 S.Ct. at p. 1912–1913.) Similarly, due respect by California courts for contractual choice-of-law provisions will assist California's resident businesses and industries to expand and prosper.

***487** The desirability of recognizing the international aspects of commercial transactions is underscored when one considers the accelerating frequency of such transactions. "In the past few decades, there has been a dramatic increase in the volume and complexity of transactions with transnational elements, especially business and commercial activity.... [T]ransactions with international elements are now routine." (Chow, *Limiting Erie in a New Age of International Law: Toward a Federal Common Law of International Choice of Law, supra,* 74 Iowa L.Rev. 165, 192–193 (fns. omitted).) As I have noted at the outset, California occupies a position of leadership in international trade, [11] and it is in the interest of this state and its residents that transactions with international aspects not be discouraged.

The reasons for giving effect to the parties' choice of law are compelling when the courts are concerned with a sophisticated transnational business transaction. When, as here, the parties to a lawsuit are large-scale international business entities of apparently equal bargaining power seeking commercial advantage, the case does not implicate the concerns the law properly has for individuals and smaller entities that may be offered contractual terms for a vital service or product on a "take-it-or-leave-it" basis by a party with greater economic power.

In this case, California's interest in respecting the parties' choice-of-law agreement is at least as strong as its interest in applying its substantive law to the transaction at issue. Because, on balance, honoring the parties' choice of governing law will serve California's interests as well or better than overriding that choice, California should not be deemed to have a materially greater interest than Hong Kong in determining whether the amended complaint states a cause of action for breach of an implied covenant of good faith and fair dealing.

Accordingly, consideration of the pertinent factors in this context leads me to conclude that California has no substantial interest in applying its law to Seawinds' cause of action for breach of the implied covenant of good faith and fair dealing.

***488** ****1167** *****349** III.
BREACH OF FIDUCIARY DUTY

A. *Existence of a Conflict*

As I have mentioned, one of the consolidated proceedings before this court involves a ruling on a demurrer to the original complaint, while the other arises from a ruling on a demurrer to the amended complaint. In its demurrer to the original complaint, Nedlloyd contended that if Hong Kong law applied, both the implied covenant and the fiduciary duty causes of action failed. In its demurrer to Seawinds' amended complaint, Nedlloyd renewed its argument that Hong Kong law applied to the breach of implied covenant cause of action, but did not renew the contention that Hong Kong law applied to the breach of fiduciary duty cause of action. The amended complaint superseded the original complaint (see 5 Witkin, Cal. Procedure (3d ed. 1985) Pleading, § 1114, p. 532), and a reviewing court ordinarily will not consider the sufficiency of a superseded pleading (*Foreman & Clark Corp. v. Fallon* (1971) 3 Cal.3d 875, 884, 92 Cal.Rptr. 162, 479 P.2d 362; *Chicago Title Ins. Co. v. Great Western Financial Corp.* (1968) 69 Cal.2d 305, 311, 70 Cal.Rptr. 849, 444 P.2d 481).

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Nevertheless, the question whether Hong Kong law applies to the fiduciary duty cause of action was properly before the trial court and the Court of Appeal, and was ruled on by those courts. The parties dispute the issue in this court; if the issue is not addressed in this proceeding, it is virtually certain it will be raised again. Inevitably, resolution of the question whether Hong Kong law governs the fiduciary duty cause of action will be required at some stage in these proceedings. Thus, it is procedurally appropriate to consider the issue here, and doing so serves the interests of judicial efficiency. (See *Sokol v. Public Utilities Commission* (1966) 65 Cal.2d 247, 256–257, 53 Cal.Rptr. 673, 418 P.2d 265.) But, because the original complaint has been superseded by the amended complaint, I will analyze the breach of fiduciary duty cause of action as pleaded in the amended, not the original, complaint.

In its amended complaint, Seawinds set forth two bases on which Nedlloyd owed it a fiduciary duty. First, Seawinds alleged that Nedlloyd was the controlling shareholder of the corporation, though not a majority shareholder, and actually exercised control. Second, Seawinds alleged that it "at all times reposed special trust and confidence in Nedlloyd," relying on ***489** Nedlloyd's expertise in the shipping industry, and Nedlloyd accepted this trust and confidence and undertook to act on Seawinds' behalf. [12]

As to the second or "trust and confidence" theory of fiduciary duty (a theory not alleged in the original complaint), the record contains no evidence of the content of Hong Kong law. Because the record fails to demonstrate that on this subject Hong Kong law and California law differ in any material way, no choice-of-law issue is presented at this stage of the proceedings by the "trust and confidence" theory of fiduciary duty.

With respect to the first or "controlling shareholder" theory of fiduciary duty, the record does contain some evidence of the content of Hong Kong law. Does this evidence demonstrate a material difference between California law and the law of Hong Kong?

The declaration of Nedlloyd's expert on Hong Kong law, William Catley, states: "Under Hong Kong law, a shareholder of a company owes no fiduciary duty to that company." Seawinds' expert on Hong Kong law, Geoffrey Miles, did not dispute this assertion in his declaration, although he had the opportunity to do so. Therefore, it is reasonable to conclude that if Hong Kong law governs Seawinds' cause of action for breach of fiduciary duty, to the extent the cause of action is premised on the "controlling shareholder" theory, it is barred.

California law, however, is to the contrary. In *Jones v. H.F. Ahmanson & Co.* (1969) 1 Cal.3d 93, 109–111, 81 Cal.Rptr. 592, 460 P.2d 464, this court held that majority ****1168** *****350** or controlling shareholders owe a fiduciary duty to minority shareholders and to the corporation itself. (See *Heckmann v. Ahmanson* (1985) 168 Cal.App.3d 119, 133, fn. 7, 214 Cal.Rptr. 177; 12B Fletcher, Cyclopedia of the Law of Private Corporations (1984 rev.) § 5811, pp. 155–156.)

Under California law, Seawinds is entitled to proceed on its breach of fiduciary duty cause of action against Nedlloyd in the latter's capacity as an alleged controlling shareholder. Under Hong Kong law, however, Seawinds is not entitled to proceed against Nedlloyd as a controlling shareholder as defined by Hong Kong law. Accordingly, a conflict of law exists.

B. *Scope of the Choice-of-law Clause*

As I noted earlier, the choice-of-law clause of the shareholders' agreement provides, in its entirety: "This Agreement shall be governed by and construed in accordance with Hong Kong law and each party hereby irrevocably ***490** submits to the non-exclusive jurisdiction and service of process of the Hong Kong courts." The parties dispute whether, under our precedents, this clause encompasses noncontractual causes of action.

Nedlloyd contends that the breach of fiduciary duty cause of action comes within the choice-of-law clause, relying on *Smith, Valentino & Smith, Inc. v. Superior Court, supra,* 17 Cal.3d 491, 497, 131 Cal.Rptr. 374, 551 P.2d 1206 (*Smith*). There, this court held that a forum-selection clause in a contract was valid with respect to the contractual cause of action. Turning to the tort causes of action, Justice Richardson wrote for the court: "Smith contends that the clause is limited in its application to breach of contract actions and should not apply to the tort counts in Smith's complaint. These counts (unfair competition and intentional interference with advantageous business relationships) arose directly out of Smith's contractual relationship with [the defendant] and reasonably may be interpreted as falling within the clause which provides for a Pennsylvania forum to litigate 'Any actions or proceedings instituted by ... [Smith] under this [a]greement with respect to any matters arising under *or growing out of this agreement*....' " (*Ibid.,* original italics.)

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By contrast, the choice-of-law clause in the contract here provided only that "[t]his Agreement shall be governed by and construed in accordance with Hong Kong law ..."; it did not include language comparable to that emphasized by the court in *Smith.* Unlike the forum-selection clause in *Smith,* it cannot be said of the choice-of-law clause in this case that it was clearly intended by the parties to encompass related noncontractual causes of action. Nor, however, can it be said that the choice-of-law clause here was plainly intended to exclude related noncontractual causes of action. Instead, the clause is ambiguous; it is not clear whether the parties intended it to govern related noncontractual causes of action.

Here, the facts alleged to form the basis for the breach of fiduciary duty cause of action are related to those alleged as the basis for the breach of contract and implied covenant causes of action, which are governed by the parties' choice of Hong Kong law. Under all three causes of action, Seawinds alleged that Nedlloyd engaged in a course of conduct aimed at forcing Seawinds out of the transpacific container shipping business so that it might obtain commercial advantage.

Because the choice-of-law clause in the parties' contract is ambiguous regarding whether it was intended to govern noncontractual causes of action, Seawinds should have alleged in the complaint its interpretation of the clause. (E.g., *Beck v. American Health Group Internat., Inc.* (1989) 211 Cal.App.3d 1555, 1561, 260 Cal.Rptr. 237 [" ' "if the instrument is ambiguous, the pleader must allege the meaning he ascribes to it" ' "]; accord, ***491** *Hillsman v. Sutter Community Hospitals* (1984) 153 Cal.App.3d 743, 749–750, 200 Cal.Rptr. 605; 4 Witkin, Cal. Procedure (3d ed. 1985) Pleading, § 477, p. 514.) Seawinds did not do so.

This pleading omission, however, is not fatal. The statutory rule is that pleadings are to be liberally construed. (****1169 ***351** Code Civ.Proc., § 452.) When a plaintiff fails to allege the meaning of an ambiguous contractual provision, but the contract containing the provision is, as in this case, set forth in an attachment to the complaint, the courts will construe the contract to determine whether it is reasonably susceptible to an interpretation sufficient to sustain the cause of action. (*Beck v. American Health Group Internat., Inc., supra,* 211 Cal.App.3d at p. 1561, 260 Cal.Rptr. 237; *Hillsman v. Sutter Community Hospitals, supra,* 153 Cal.App.3d at p. 750, 200 Cal.Rptr. 605.) As I have explained, the choice-of-law provision in this case is ambiguous. It necessarily follows that the clause is reasonably susceptible of an interpretation that does not encompass noncontractual causes of action; therefore, this court is required to so construe it at the pleading stage. Any other approach would be inconsistent with the settled rules of pleading.

Accordingly, because the choice-of-law clause in this case does not unambiguously extend to noncontractual causes of action, it should not be applied by the trial court in determining whether the plaintiff has stated a cause of action for breach of fiduciary duty. [13]

C. *Defects of the Majority's Approach*

In an earlier part of this opinion, I have emphasized the particular need for predictability and protection of the parties' justified contractual expectations in the commercial context. Until today, California law governing contractual choice-of-law and choice-of-forum provisions served that need. Sophisticated commercial parties who desired choice-of-law and choice-of-forum provisions to control all related contractual and noncontractual aspects of their relationship could achieve their aim by using clauses that resembled those this court enforced in *Smith, supra,* 17 Cal.3d 491, 131 Cal.Rptr. 374, 551 P.2d 1206, governing "any ***492** matters arising under or growing out of the agreement." Other sophisticated parties who desired more narrow clauses could draft specific clauses suited to the parties' needs in the expectation that those clauses would be enforced as they were intended.

But under the majority's approach, as I understand it, when two commercial entities agree to a choice-of-law clause in a contract, as a matter of law the clause applies to all conceivably related noncontractual causes of action, regardless of any ambiguous language in the clause or of the parties' actual intent regarding its coverage. The party resisting application of the choice-of-law clause will have no opportunity to show that it was intended to apply only to contractual causes of action. This rigid rule has, in my view, serious defects.

The majority ignores the most fundamental statutory command of contract law interpretation: "A contract must be so interpreted as to give effect to the mutual intention of the parties as it existed at the time of contracting, so far as the same is ascertainable and lawful." (Civ.Code, § 1636; see Code Civ.Proc., § 1859 ["In the construction of a statute the intention of the Legislature, and in the construction of an

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instrument the intention of the parties, is to be pursued, if possible; ..."].)

It is not at all difficult to foresee situations in which contracting parties intend a choice-of-law clause such as the one at issue here to govern only contractual causes of action. A party could demonstrate such intent by showing, for example, that the scope of the choice-of-law clause was a ****1170 ***352** subject of negotiation, and that early drafts of the parties' agreement contained a choice-of-law clause similar to the clause in *Smith, supra,* 17 Cal.3d 491, 131 Cal.Rptr. 374, 551 P.2d 1206, while the final version, after negotiation, more resembled the clause at issue here. Such documentary evidence of negotiation that successively narrowed the scope of the clause would strongly indicate that the parties intended the clause to apply only to contractual causes of action.

But the majority would simply disregard the parties' intent even in cases in which it could be demonstrated that the parties intended the choice-of-law clause *not* to apply to noncontractual causes of action. The majority would do so in direct violation of the command of Civil Code section 1636, which requires the courts to ascertain and give effect to the intention of the parties. And the majority would do so in the name of "certainty and predictability," while, ironically, defeating the expectations of the parties that the choice-of-law clause would, certainly and predictably, apply only to contractual causes of action.

It is unrealistic to conclude that the choice-of-law clause in this case is not ambiguous. Certainly, reasonable minds may differ as to whether the clause ***493** in this case, which states only that "[t]his Agreement shall be governed by and construed in accordance with Hong Kong law ...," should be interpreted to cover noncontractual causes of action. Indeed, the ambiguity in the scope of this clause proceeds not so much from its language as from its context. Taken without reference to context, the clause *is* unambiguous, but not in the manner suggested by the majority. Because the clause refers only to "this Agreement," and not, like the similar clause at issue in *Smith,* to " 'matters arising under *or growing out of this agreement*.....' " (*Smith, supra,* 17 Cal.3d at p. 497, 131 Cal.Rptr. 374, 551 P.2d 1206 (italics in original)), it appears on its face not to apply to noncontractual causes of action.

Given the context of the agreement, the parties may well have intended a clause that would assure that all their disputes would be governed by Hong Kong law, but simply have failed to make this explicit. On the other hand, the parties may well have intended what Justice Panelli, in his separate opinion, joined by Justice Mosk, assumes they intended: that only their contract disputes be governed by Hong Kong law. Indeed, the very fact that Justices Panelli and Mosk disagree with the majority regarding the meaning of the clause, and that both the majority and these two justices find the clause clear, but conclude it has opposite meanings, ironically and convincingly demonstrates that the clause *is* ambiguous.

Even under circumstances in which the ambiguity arises more from context than language, extrinsic evidence is admissible to show the meaning the parties intended. The majority mistakenly assumes that, because the term "this Agreement" means to four members of this court "this Agreement and all related controversies," it could reasonably have no different meaning to the parties or anyone else. Outside of the choice-of-law area, however, the courts of this state have rejected such a narrow view of meaning. As Chief Justice Traynor put it in the landmark case of *Pacific Gas & E. Co. v. G.W. Thomas Drayage etc. Co.* (1968) 69 Cal.2d 33, 38–39, 69 Cal.Rptr. 561, 442 P.2d 641 (*Pacific Gas*): "[T]he meaning of a writing '... can only be found by interpretation in light of all the circumstances that reveal the sense in which the writer used the words. The exclusion of parol evidence regarding such circumstances merely because the words do not appear ambiguous to the reader can easily lead to the attribution to a written instrument of a meaning that was never intended....' [Citations.]"

Under the majority's approach, "contractual obligations flow, not from the intention of the parties but from the fact that they used certain magic words." (*Pacific Gas, supra,* 69 Cal.2d at p. 38, 69 Cal.Rptr. 561, 442 P.2d 641.) The majority's primitive "magic words" approach is inconsistent with statutory rules of contract interpretation.

***494 **1171 ***353** The majority's approach is also inconsistent with the approach taken by Justice Richardson in his thoughtful opinion for this court in *Smith, supra,* 17 Cal.3d 491, 131 Cal.Rptr. 374, 551 P.2d 1206. There, Justice Richardson interpreted the meaning of a choice-of-forum clause by focusing on the particular language chosen by the parties, as the language reflects the parties' intent. Without admitting it, the majority has abandoned this traditional and sound approach.

IV. CONCLUSION

Parties enter into contracts to allocate risks and to bring certainty, order, and predictability to their mutual relations. One of the principal aims of contract law is to assist contracting parties in achieving this objective by making the outcome of legal disputes clear and predictable. When the parties are residents of different jurisdictions, or their activities span state or national borders, the potential application of the varying legal rules of different jurisdictions undermines the parties' efforts to avoid unexpected legal consequences. When the parties have anticipated and provided for this problem by including in their agreement a choice-of-law provision, courts should generally give effect to the provision. In so doing, courts protect the parties' reasonable expectations and establish a legal climate in which commerce can flourish.

In this case, the parties have elected to have their agreement governed by Hong Kong law. Applying the test articulated in the Restatement Second of Conflict of Laws, I conclude, like the majority, that Hong Kong law, the law expressly chosen by the parties, should be applied to Seawinds' contractual cause of action for breach of the implied covenant of good faith and fair dealing. But the goal of protecting contracting parties' reasonable expectations is not served by applying Hong Kong law to Seawinds' noncontractual cause of action for breach of fiduciary duty. Absent extrinsic evidence that the parties intended a broader application of their choice-of-law provision, the choice-of-law provision is most reasonably interpreted as applying only to contractual causes of action. Unlike the majority, therefore, I conclude that the trial court should not apply Hong Kong law to determine whether Seawinds has stated a cause of action for breach of fiduciary duty.

All Citations

3 Cal.4th 459, 834 P.2d 1148, 11 Cal.Rptr.2d 330, 1994 A.M.C. 531

Footnotes

1 Federal courts applying California's conflicts law have also adhered to this approach. (*Consul Ltd. v. Solide Enterprises, Inc.* (9th Cir.1986) 802 F.2d 1143, 1146–1147; *S.A. Empresa, Etc. v. Boeing Co.* (9th Cir.1981) 641 F.2d 746, 749; *Sarlot–Kantarjian v. First Pa. Mortg. Trust* (9th Cir.1979) 599 F.2d 915, 917.) The mainstream nature of this approach is further reflected by a recent study indicating that 15 states other than California follow the general approach of the Restatement Second. (Chow, *Limiting Erie in a New Age of International Law: Toward a Federal Common Law of International Choice of Law* (1988) 74 Iowa L.Rev. 165, 190–191.)

2 There may be an exception to application of the Restatement approach. Choice-of-law issues arising from contracts subject to the Uniform Commercial Code are governed by California Commercial Code section 1105, subdivision (1), which provides that, subject to specified exceptions, the parties may choose the law of a state having a “reasonable relation” to the transaction. This “reasonable relation” test appears to be similar to the “substantial relationship” test we adopt from the Restatement. (See official code com. to U.Com.Code § 1–105 [Deering's Ann.Cal.U.Com.Code, § 1105 (1986 ed.) p. 10; 23A West's Ann.Cal.U.Com.Code, § 1105 (1964 ed.) p. 37.].) Neither party to this action, however, contends that California Uniform Commercial Code section 1105 applies to their contract. We therefore need not and do not determine whether and to what extent, if any, the Commercial Code and Restatement approaches are different.

3 Subdivision (1) of section 187 of the Restatement states: “(1) The law of the state chosen by the parties to govern their contractual rights and duties will be applied if the particular issue is one which the parties could have resolved by an explicit provision in their agreement directed to that issue.” As comment c to section 187, subdivision (1) explains: “The rule of this Subsection is a rule providing for incorporation by reference and is not a rule of choice of law. The parties, generally speaking, have power to determine the terms of their contractual engagements. They may spell out these terms in the contract. In the alternative, they may

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incorporate into the contract by reference extrinsic material which may, among other things, be the provisions of some foreign law.... [M]ost rules of contract law are designed to fill gaps in a contract which the parties could themselves have filled with express provisions." (Rest., § 187, subd. (1), com. c, p. 563.) The record in this case does not indicate that the parties incorporated by reference extrinsic material in the form of Hong Kong law in order to fill a gap in their contract. Subdivision (1) therefore is not at issue, and we need not and do not further consider its potential application or scope.

4 As noted above, a different result might obtain under Restatement section 187, subdivision (1), which appears to allow the parties *in some circumstances* to specify the law of a state that has no relation to the parties or their transaction. The Restatement gives these two illustrations: "4. In State X, A establishes a trust and provides that B, the trustee, shall be paid commissions at the highest rate permissible under the local law of state Y. *A and B are both domiciled in X, and the trust has no relation to any state but X.* In X, the highest permissible rate of commissions for trustees is 5 per cent. In Y, the highest permissible rate is 4 per cent. The choice-of-law provision will be given effect, and B will be held entitled to commissions at the rate of 4 per cent. [¶] 5. Same facts as in Illustration 4 except that the highest permissible rate of commissions in X is 4 per cent and in Y is 5 per cent. Effect will not be given to the choice-of-law provision since under X local law the parties lacked power to provide for a rate of commissions in excess of 4 per cent and Y, the state of the chosen law, has no relation to the parties or the trust." (Rest., § 187, subd. (1), com. c., illus. 4 & 5, p. 564; italics added.)

5 To be more precise, we note that Restatement section 187, subdivision (2) refers not merely to the forum state—for example, California in the present case—but rather to the state "... which, under the rule of § 188, would be the state of the applicable law in the absence of an effective choice of law by the parties." For example, there may be an occasional case in which California is the forum, and the parties have chosen the law of another state, but the law of yet a third state, rather than California's, would apply absent the parties' choice. In that situation, a California court will look to the fundamental policy of the third state in determining whether to enforce the parties' choice of law. The present case is not such a situation.

6 There may also be instances when the chosen state has a materially greater interest in the matter than does California, but enforcement of the law of the chosen state would lead to a result contrary to a fundamental policy of California. In some such cases, enforcement of the law of the chosen state may be appropriate despite California's policy to the contrary. (*S.A. Empresa, Etc. v. Boeing Co., supra,* 641 F.2d 746, 749.) Careful consideration, however, of California's policy and the other state's interest would be required. No such question is present in this case, and we thus need not and do not decide how Restatement section 187 would apply in such circumstances.

7 As we have noted, the choice-of-law clause states: "This agreement shall be governed by and *construed in accordance with Hong Kong law* ...." (Italics added.) The agreement, of course, includes the choice-of-law clause itself. Thus the question of whether that clause is ambiguous as to its scope (i.e., whether it includes the fiduciary duty claim) is a question of contract interpretation that in the normal course should be determined pursuant to Hong Kong law. (*S.A. Empresa, Etc. v. Boeing Co., supra,* 641 F.2d 746, 751 [interpreting choice-of-law clause pursuant to law chosen by the parties]; *McGill v. Hill* (1982) 31 Wash.App. 542, 644 P.2d 680, 683.) The parties in this case, however, did not request judicial notice of Hong Kong law on this question of interpretation (Evid.Code, § 452, subd. (f)) or supply us with evidence of the relevant aspects of that law (Evid.Code, § 453, subd. (b)). The question therefore becomes one of California law. (*Com'l Ins. Co. of Newark v. Pacific–Peru Const.* (9th Cir.1977) 558 F.2d 948, 952; Rest., § 136, subd. (2), com. h, p. 378.)

1 I agree with the majority that the scope of the choice-of-law clause in this contract is a question that would ordinarily be determined under Hong Kong law. (Maj. opn., *ante,* at p. 336, fn. 7 of 11 Cal.Rptr.2d, p. 1154, fn. 7 of 834 P.2d.) I further agree with the majority that, since the parties neither produced any evidence of

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Hong Kong law relating to this subject nor requested judicial notice of any such law, we may apply California law to ascertain the scope of the clause. (*Ibid.*)

2 Despite the majority's artfully crafted argument, the words "governed by" do not assist in defining what causes of action the choice-of-law clause was intended to address. Rather, the parties defined the scope of their choice-of-law clause by choosing the phrase "[t]his agreement."

1 Seawinds did not, however, purchase its own shares.

2 The complaint named Nedlloyd Lines B.V. as the first defendant, and alleged alter ego relationships between it and Royal Nedlloyd Group N.V. and KNSM Lines B.V. According to the complaint, Royal Nedlloyd Group N.V. owns 100 percent of both Nedlloyd Lines B.V. and KNSM Lines B.V.

3 The Court of Appeal at first denied the writ petition summarily. This court then granted Nedlloyd's petition for review, and transferred the matter back to the Court of Appeal with directions to issue an alternative writ.

4 Because a demurrer raises only questions of law (Code Civ.Proc., § 589), trial courts ordinarily do not consider evidence in connection with a demurrer. But a court may consider matters subject to judicial notice when ruling on a demurrer, and foreign law is subject to judicial notice (Evid.Code, § 452, subd. (f)). In taking judicial notice, a court may rely on "the advice of persons learned in the subject matter ... whether or not furnished by a party." (Evid.Code, § 454, subd. (a)(1); see *Estate of Chichernea* (1967) 66 Cal.2d 83, 86, fn. 2, 57 Cal.Rptr. 135, 424 P.2d 687; *City of Los Angeles v. City of San Fernando* (1975) 14 Cal.3d 199, 231, 123 Cal.Rptr. 1, 537 P.2d 1250; *Volkswagenwerk Aktiengesellschaft v. Superior Court* (1981) 123 Cal.App.3d 840, 852, 176 Cal.Rptr. 874.)

5 The clause provides: "Each Shareholder agrees that he or it will at all times: [¶] (a) use all means reasonably available to him or it ... so as to insure that the Company [Seawinds] shall implement the provisions of this agreement ...; and [¶] (b) cooperate in good faith and execute such further documents and take such other action as may be reasonably required in order to give full effect to the provisions and intent of this agreement."

6 There is an exception. Choice-of-law issues arising from contracts that are subject to the Uniform Commercial Code are governed by California Uniform Commercial Code section 1105, which provides in pertinent part that, subject to certain exceptions, the parties may choose the law of a state having a "reasonable relation" to the transaction. Neither party contends that California Uniform Commercial Code section 1105 applies in this case. The California Uniform Commercial Code's "reasonable relation" test is in any event similar to the "substantial relationship" test I apply. (See official code com. to U.Com.Code § 1–105 [Deering's Ann.Cal.U.Com.Code, § 1105 (1986 ed.) p. 10; 23A West's Ann.Cal.U.Com.Code, § 1105 (1964 ed.) p. 37].)

7 Section 187 of the Restatement Second of Conflict of Laws provides:

"(1) The law of the state chosen by the parties to govern their contractual rights and duties will be applied if the particular issue is one which the parties could have resolved by an explicit provision in their agreement directed to that issue.

"(2) The law of the state chosen by the parties to govern their contractual rights and duties will be applied, even if the particular issue is one which the parties could not have resolved by an explicit provision in their agreement directed to that issue, unless either [¶] (a) the chosen state has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties[']choice, or [¶] (b) application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue and which,

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under the rule of [section] 188, would be the state of the applicable law in the absence of an effective choice of law by the parties.

> "(3) In the absence of a contrary indication of intention, the reference is to the local law of the state of the chosen law."

California courts have frequently employed the "substantial relationship" and "strong policy" tests without reference to the Restatement Second of Conflict of Laws. (See, e.g., *Hall v. Superior Court, supra,* 150 Cal.App.3d at p. 417, 197 Cal.Rptr. 757; *Ashland Chemical Co. v. Provence, supra,* 129 Cal.App.3d at p. 794, 181 Cal.Rptr. 340; *Frame v. Merrill Lynch, Pierce, Fenner & Smith, Inc., supra,* 20 Cal.App.3d at p. 673, 97 Cal.Rptr. 811.) Those California courts that have cited the Restatement Second of Conflict of Laws have typically focused on section 187, subdivision (2), as have the courts of other jurisdictions.

The Restatement comment to subdivision (1) explains: "The rule of this Subsection is a rule providing for incorporation by reference and is not a rule of choice of law. The parties, generally speaking, have power to determine the terms of their contractual agreements. They may spell out these terms in the contract. In the alternative, they may incorporate into the contract by reference extrinsic material which may, among other things, be the provisions of some foreign law. ... [M]ost rules of contract law are designed to fill gaps in a contract which the parties could themselves have filled with express provisions." (Rest.2d Conf. of Laws, § 187, subd. (1), com. c., p. 563.) Here, there is no indication that the parties incorporated by reference extrinsic material in the form of Hong Kong law in order to fill a gap in the contract. Accordingly, subdivision (1) is not at issue, and I do not further consider its potential scope.

8 According to one recent study, fifteen states, not including California, follow the general approach of the Restatement Second; nineteen states adhere to the first Restatement, under which the court applies the law of the place where the contract was made, regardless of the parties' choice; three states and the District of Columbia employ a "center of gravity" approach; three states use a "governmental interests" approach or some variant; and in nine states the rule is unclear. (Chow, *Limiting Erie in a New Age of International Law: Toward a Federal Common Law of International Choice of Law* (1988) 74 Iowa L.Rev. 165, 190–191.) The parties do not urge this court to adopt any of the three other general approaches that have found some favor in the courts; I deem the general approach adopted by the California courts and the Restatement Second to be the most appropriate, because it is the only framework that accords any substantial weight to the parties' choice, as I discuss below.

9 As an alternative, a party seeking enforcement of a contractual choice-of-law clause may also show that there is, in the language of the Restatement Second of Conflict of Laws, some "other reasonable basis for the parties[']choice...." (Rest.2d Conf. of Laws, § 187, subd. (2)(a).) Comment f to section 187 of the Restatement Second provides this illustration:

> "For example, when contracting in countries whose legal systems are strange to them as well as relatively immature, the parties should be able to choose a law on the ground that they know it well and that it is sufficiently developed. For only in this way can they be sure of knowing accurately the extent of their rights and duties under the contract. So parties to a contract for the transportation of goods by sea between two countries

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> with relatively undeveloped legal systems should be permitted to submit their contract to some well-known and highly elaborated commercial law."

10 Seawinds argues that these contacts are shown by a declaration of its managing director, Bengt Henriksen. As noted earlier, evidentiary submissions are not cognizable at the pleading stage. This is true even when, as here, the evidentiary submissions are contained in a declaration that was part of the record in a prior lawsuit. Accordingly, I decline to consider Henriksen's declaration.

11 California leads the United States in exporting, accounting for one out of every seven export dollars. "In 1991, California exported over $63 billion in goods.... California ports handled two-way trade valued at nearly $175 billion." (Cal. State World Trade Com., 1991 Cal.Trade Highlights, p. 1.) Between 1987 and 1990, exports increased by an average of 20 percent per year. Exports represented "approximately 60 percent of the state's real economic growth in 1991." (*Ibid.*) Foreign investment in California exceeded $60 billion in 1989 (the latest year for which figures are available), and total employment in California attributable to foreign investment was 496,400 in 1989. (*Id.* at p. 2.)

12 In the original complaint, Seawinds alleged only that "the [s]hareholders' [a]greement created a fiduciary relationship" between it and Nedlloyd.

13 Nedlloyd also contends that the "internal affairs" doctrine compels a decision in its favor on the breach of fiduciary duty cause of action. The doctrine's status in California is doubtful; it has been criticized as inconsistent with the state's general approach to resolving conflict-of-laws questions. (*Wilson v. Louisiana–Pacific Resources, Inc.* (1982) 138 Cal.App.3d 216, 224, 187 Cal.Rptr. 852.) But even assuming the internal affairs doctrine should be followed in California, resolution of the issue under that doctrine would require a determination whether California or Hong Kong has a "more significant relationship" to the parties under section 306 of the Restatement Second of Conflict of Laws. This question is essentially factual, and thus ill-suited to resolution at the pleading stage. For this reason, and because Nedlloyd failed to raise the internal affairs doctrine in the trial court or in the Court of Appeal, I decline to address it here.

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51 Cal.3d 701
Supreme Court of California.

SOUTHWEST CONCRETE PRODUCTS,
Plaintiff, Cross-defendant and Appellant,
v.
GOSH CONSTRUCTION CORPORATION., et al.,
Defendants, Cross-complainants and Appellants;
Armco, Inc., Cross-defendant and Appellant.

No. S012846.
|
Nov. 1, 1990.

Synopsis

Pipe supplier sued construction company to recover balance allegedly owing under supply agreement. The Superior Court, Riverside County, Frank R. Moore, J., entered judgment in favor of supplier and denied construction company's motion for judgment notwithstanding the verdict based on alleged usurious nature of supplier's late charges, and construction company appealed. The Court of Appeal, 263 Cal.Rptr. 387, reversed and remanded. Review was granted, superseding the opinion of the Court of Appeal. The Supreme Court, Panelli, J., held that late charge of one-and-one-half percent per month which supplier charged when customer failed to make timely payment on invoice was not subject to state usury law.

Judgment of Court of Appeal affirmed.

Mosk, J., concurred in part and dissented in part and filed opinion, in which Broussard, J., joined.

Procedural Posture(s): On Appeal.

Attorneys and Law Firms

***703** ****1248** *****405** Feldsott & Lee and Martin L. Lee, Newport Beach, for cross-defendant and appellant, Armco, Inc.

Robert L. Kern, Pomona, for plaintiff, cross-defendant and appellant, Southwest Concrete Products.

Joseph M. Loomis, San Mateo, amicus curiae, on behalf of plaintiff, cross-defendant and appellant.

***704** Jones, Mahoney & Brayton, Paul M. Mahoney and Richard A. Soll, Pomona, for ****1249** *****406** defendants, cross-complainants and appellants, Gosh Const. Corp., et al.

Opinion

PANELLI, Associate Justice.

We granted review in this matter to resolve a conflict among the Courts of Appeal on the issue of whether a provision in a commercial sales contract which calls for interest of 18 percent per year on late payments violates the usury law. Although the petition for review had raised other issues as well, our order limited review to the usury question.

We conclude that interest payments on overdue commercial accounts are not subject to the usury law and disapprove *Crestwood Lumber Co. v. Citizens Sav. & Loan Assn.* (1978) 83 Cal.App.3d 819, 148 Cal.Rptr. 129 and *Mark McDowell Corp. v. LSM 128* (1989) 214 Cal.App.3d 1427, 263 Cal.Rptr. 310, which held to the contrary.

In the present case, Gosh Construction Corporation and Lawrence Gosh (collectively, Gosh) formed a joint venture to install sewer pipe in the City of Palm Springs. Gosh purchased the pipe from Southwest Concrete Products; the pipe was manufactured by Armco, Inc. A dispute arose about the quality of the pipe, and Gosh failed to pay for it. Southwest brought suit to recover the unpaid balance. Gosh cross-complained against Southwest and Armco for breach of contract and negligence, alleging that the pipe was defective. Armco was granted a nonsuit before the case went to the jury. The jury found in favor of Southwest and against Gosh on the complaint and the cross-complaint.

The jury found, on the basis of a special verdict, that the delivery tickets and invoices that accompanied the pipe constituted a contract with Southwest, that Gosh breached the contract, and that the contract contained an attorney fees clause and a provision for interest of 1 ½ percent per month (18 percent per year) on late payments. The trial court awarded Southwest prejudgment interest at the rate of 18 percent per year based on the contract. It also awarded Southwest attorney fees of $13,077 under Civil Code section 1717. Armco's motion for attorney fees was denied on the ground it was not a party to the contract. Gosh moved for a new trial and for judgment notwithstanding the verdict on the ground that the prejudgment interest of 18 percent was usurious. The trial court denied the motion.

All parties appealed. The Court of Appeal, in the published portion of its opinion, affirmed the award of prejudgment interest at the rate of 18 ***705** percent, holding that the late

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charge was not subject to the usury law. In the unpublished portion of its opinion, the Court of Appeal reversed and remanded on other issues.

The law of usury in California is based upon California Constitution article XV, section 1, which limits the interest payable "[f]or any loan or forbearance of any money." [1] A loan of money is the delivery of a sum of money to another under a contract to return at some future time an equivalent amount. A forbearance of money is the giving of further time for the payment of a debt or an agreement not to enforce a claim at its due date. (*Boerner v. Colwell Co.* (1978) 21 Cal.3d 37, 44, fn. 7, 145 Cal.Rptr. 380, 577 P.2d 200.) However, "both a loan of money and a forbearance are to be distinguished from a sale which is the 'transfer of property in a thing for a price in money.' " (*O'Connor v. Televideo System, Inc.* (1990) 218 Cal.App.3d 709, 713, 267 Cal.Rptr. 237.) In determining whether a transaction constitutes a loan or forbearance, we look to the substance rather than the form of the transaction. "In all such cases the issue is whether or not the bargain of the parties, assessed in light of all the circumstances and with a view to substance rather than form, has as its true object the hire of money at an excessive rate of interest." ****1250** *****407** (*Boerner v. Colwell Co., supra,* 21 Cal.3d at p. 44, 145 Cal.Rptr. 380, 577 P.2d 200.)

There are many exceptions to the usury law. (See Rabin & Brownlie, *Usury Law in California: A Guide Through the Maze* (1987) 20 U.C. Davis L.Rev. 397.) Two of the exceptions are applicable here. One is the "time-price" doctrine. This doctrine applies when property is sold on credit as an advance over the cash price. In these circumstances, the seller finances the purchase of property by extending payments over time and charging a higher price for carrying the financing. This type of transaction, often called a bona fide credit sale, is not subject to the usury law because it does not involve a loan or forbearance. (*Boerner v. Colwell Co., supra,* 21 Cal.3d at p. 45, 145 Cal.Rptr. 380, 577 P.2d 200; *Verbeck v. Clymer* (1927) 202 Cal. 557, 563, 261 P. 1017; *O'Connor v. Televideo System, Inc., supra,* 218 Cal.App.3d at p. 714, 267 Cal.Rptr. 237.) As explained in *Verbeck:* " 'On principle and authority, the owner of property, whether real or personal, has a perfect right to name the price on which he is willing to sell, and to refuse to accede to any other. He may offer to sell at a designated price for cash or at a much higher price on credit, and a credit sale will not constitute usury however great the difference between the two prices, ***706** unless the buying and selling was a mere pretense....' " (*Verbeck v. Clymer, supra,* 202 Cal. at p. 563, 261 P. 1017.)

Another exception to the usury laws is the rule that a debtor by voluntary act cannot render an otherwise valid transaction usurious. "[A] debtor cannot bring his creditor to the penalties of the Usury Law by his voluntary default in respect to the obligation involved where no violation of law is present at the inception of the contract." (*Sharp v. Mortgage Security Corp.* (1932) 215 Cal. 287, 291, 9 P.2d 819.) Where the excessive interest is caused by a contingency under the debtor's control, the transaction will not be deemed usurious. (*Ibid.; Penziner v. West American Finance Co.* (1933) 133 Cal.App. 578, 590, 24 P.2d 501; *Abbot v. Stevens* (1955) 133 Cal.App.2d 242, 247, 284 P.2d 159.)

Gosh correctly contends that their position—that the late charge is usurious—is supported by *Crestwood Lumber Co. v. Citizens Sav. & Loan Assn., supra,* 83 Cal.App.3d 819, 148 Cal.Rptr. 129. In *Crestwood,* a lumber company sold lumber for real property improvements. The sales orders and invoices stated that payment was due within 10 days from date of invoice and that a finance charge of 1 ½ percent per month (18 percent per year) would be charged on all overdue accounts. The buyer failed to pay, and the lumber company brought suit. The trial court found the interest rate usurious and void. The Court of Appeal affirmed, holding that the finance charge was interest upon a forbearance of money and was therefore subject to the usury laws.

Crestwood, supra, 83 Cal.App.3d 819, 148 Cal.Rptr. 129, was followed recently in *Mark McDowell Corp. v. LSM 128, supra,* 214 Cal.App.3d 1427, 263 Cal.Rptr. 310. [2] In *Mark McDowell,* the plaintiff, a subcontractor, contracted with the defendant to do rough grading work on a construction project. Under the terms of the agreement, the plaintiff was to bill the defendant for work performed, and the defendant was to pay each bill within a specified number of days. The contract provided that sums not paid when due would thereafter bear interest at the rate of 1 ½ percent per month. The defendant failed to pay, and the plaintiff sued for the unpaid balance and interest. The trial court found the interest rate usurious and awarded only 10 percent interest. The Court of Appeal affirmed, relying on *Crestwood.*

The Court of Appeal in the present case refused to follow *Crestwood, supra,* 83 Cal.App.3d 819, 148 Cal.Rptr. 129. It noted that *Crestwood* had been criticized by legal commentators (Hogan, *Is There a Cap on Service Charges?* ***707** (1987) 7 Cal.Law. 30; ****1251** *****408** Loomis, *Crestwood Lumber Company v. Citizens Savings & Loan*

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Association: The Usury Law and Liquidated Damages in Sale of Goods Transactions (1980) 10 Golden Gate L.Rev. 553) and that its reasoning had been undercut by *Fox v. Federated Department Stores, Inc.* (1979) 94 Cal.App.3d 867, 156 Cal.Rptr. 893. [3] The court found no valid distinction between the present transaction and the service charges on retail department store and oil company charge accounts which were held in *Fox* not to violate the usury laws.

In *Fox,* retail department stores and oil companies imposed monthly charges of 1 to 1 ½ percent on unpaid account balances. The plaintiffs, who were purchasers of goods and services, argued that such charges constituted usury and that the Unruh Act, which allowed finance charges in excess of the limit imposed by California Constitution article XV, was unconstitutional. [4] The court in *Fox* held that a "time-price" or a "finance charge" in a bona fide sale of goods or services is not a form of interest within the meaning of article XV of the California Constitution's proscription against usury. It further held that the sales by the defendants of their goods and services are bona fide sales to which the time-price doctrine applies. (*Fox v. Federated Department Stores, Inc., supra,* 94 Cal.App.3d at p. 872, 156 Cal.Rptr. 893.) It also upheld the constitutionality of the Unruh Act, which allows finance charges in excess of usury limits, on the ground that the transactions it regulates are within the time-price doctrine and thus not subject to the usury laws. (*Id.* at p. 880, 156 Cal.Rptr. 893.)

In the present case, the Court of Appeal found the reasoning of *Fox* directly applicable to the transaction at issue here. It is exempt from the usury laws because it was a bona fide credit sale. This is true regardless of whether the Unruh Act applies to the transaction. The court in *Fox* recognized this when it responded to the argument that the Unruh Act did not apply to the oil company defendants because they sold through independent dealers and thus were not retailers: "The sales through their independent dealers are not exempt because the Unruh Act exempts them, but because the transactions are good faith credit sales of their products. This good faith sale of products was recognized as not subject to the usury limitation before the enactment of the Unruh Act." (*Fox v. Federated Department Stores, Inc. supra,* 94 Cal.App.3d at p. 873, 156 Cal.Rptr. 893.)

***708** Another reason given by the Court of Appeal for not following *Crestwood* (*supra,* 83 Cal.App.3d 819, 148 Cal.Rptr. 129) was that *Crestwood* failed to consider the California Uniform Commercial Code when it concluded that the late charge did not qualify as a liquidated damage provision because the parties had not agreed to it. The court here noted that under section 2207 of the California Uniform Commercial Code, the clause providing for late charges on overdue invoices became part of the contract. Section 2207 provides that additional terms become part of a contract between merchants unless the person receiving them objects to them. The official code comment to this section lists as an example of such additional terms "a clause providing for interest on overdue invoices...." (23A West's Ann.Cal.U.Com.Code (1964 ed.) § 2207, com. 5, p. 175.)

We agree with the Court of Appeal that *Crestwood, supra,* 83 Cal.App.3d 819, 148 Cal.Rptr. 129, should not be followed. This was not a cash sale, as the *Crestwood* court believed. A cash sale is one where the buyer and seller exchange the goods and payment at the same time; any other method of payment is "on credit." The transaction in this case was a credit sale. Payment was to be made within a certain ****1252** *****409** number of days after delivery of the pipe; if payment was not made by that date, then finance charges would accrue. There was no forbearance here. As previously noted, a forbearance is the giving of further time for payment of a debt or an agreement not to insist upon payment at the due date. (*Boerner v. Colwell Co., supra,* 21 Cal.3d at p. 44, fn. 7, 145 Cal.Rptr. 380, 577 P.2d 200.) "If the invoice [s] truly constituted an agreement to give further time for payment in exchange for an 18 percent surcharge on the principal, then the buyer could conceivably forbear ad infinitum, so long as the finance charge was paid, and the creditor could never recover the principal. The creditor would never be able to sue to collect the money past due because it was receiving consideration for its agreement to forbear on the account." (*O'Connor v. Televideo System, Inc., supra,* 218 Cal.App.3d at p. 717, 267 Cal.Rptr. 237.)

Both *Crestwood* (*supra,* 83 Cal.App.3d 819, 148 Cal.Rptr. 129) and *Mark McDowell* (*supra,* 214 Cal.App.3d 1427, 263 Cal.Rptr. 310) also failed to apply, or even discuss, the rule that a transaction that was not usurious at its inception cannot become usurious by virtue of the debtor's voluntary default. As the court in *O'Connor v. Televideo System, Inc., supra,* 218 Cal.App.3d at pages 716–717, 267 Cal.Rptr. 237, stated: "This precept has been expressed in a number of California cases. (*Sharp v. Mortgage Security Corp., supra,* 215 Cal. at p. 291 [9 P.2d 819]; *Penziner v. West American Finance Co., supra,* 133 Cal.App. at p. 590 [24 P.2d 501]; see also *French v. Mortgage Guarantee Co.* [(1940)] 16 Cal.2d [26,] 33 [104 P.2d 655]; *Abbot v. Stevens, supra,* 133 Cal.App.2d at p. 247

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[284 P.2d 159]; *First American Title Ins.* ***709** *& Trust Co. v. Cook* [(1970)] 12 Cal.App.3d [592,] 596 [90 Cal.Rptr. 645]; *Fox v. Federated Department Stores, supra,* 94 Cal.App.3d at p. 884 [156 Cal.Rptr. 893].) It has also been recognized by numerous other authorities. (See, e.g., 1 Witkin, Summary of Cal.Law (9th ed. 1987) Contracts, § 487, p. 434; 47 C.J.S., Interest & Usury § 140, p. 257; *Scientific Products v. Cyto Medical Laboratory, Inc.* ([D.Conn.] 1978) 457 F.Supp. 1373, 1379; *Rangen, Inc. v. Valley Trout Farms, Inc.* (1983) 104 Idaho 284 [658 P.2d 955]; *Union Bank v. Kruger* (1969) 1 Wn.App. 622 [463 P.2d 273].)" That principle applies here as well.

We further agree with the Court of Appeal's analysis of the California Uniform Commercial Code. The late charges became part of the contract under section 2207 of the California Uniform Commercial Code. Indeed, the jury expressly found that the delivery tickets and invoices that accompanied the pipe constituted a contract which included the provision for 1 ½ percent interest per month on late payments.

To summarize, we conclude that the late charge provided in the contract is not subject to the usury law because it does not constitute payment for the "loan or forbearance of any money." (Cal. Const., art. XV, § 1.) It is exempt from the usury law under the time-price doctrine and the principle that a debtor by voluntary act cannot render an otherwise valid contract usurious. In light of our limitation of review to the issue of usury, we do not reach the question urged by amicus curiae regarding the validity of the late charge as a liquidated damage provision.

The judgment of the Court of Appeal is affirmed.

LUCAS, C.J., and EAGLESON, KENNARD and ARABIAN, JJ., concur.

MOSK, Associate Justice, concurring and dissenting.

The majority aptly state their holdings as follows: "To summarize, we conclude that the late charge provided in the contract is not subject to the usury law because it does not constitute payment for the 'loan or forbearance of any money.' (Cal. Const., art. XV, § 1.) It is exempt from the usury law under [1] the time-price doctrine and [2] the principle that a debtor by voluntary act cannot render an otherwise valid contract usurious." (Maj. opn., *ante,* p. 409 of 274 Cal.Rptr., p. 1252 of 798 P.2d.) In my view, the holding stated in the first of the quoted sentences is correct and fully disposes of the usury claim in this case; ****1253** *****410** the two holdings stated in the second sentence, however, are incorrect and unnecessary to the decision.

***710** I

As the majority correctly observe, the usury law set forth in our Constitution applies only to a "loan or forbearance." (Cal. Const., art. XV, § 1.) [1] If the transaction is neither a "loan" nor a "forbearance," it is not subject to the usury law no matter what its terms. And in determining whether the transaction is a loan or a forbearance, courts look to substance rather than form. (*Boerner, v. Colwell Co.* (1978) 21 Cal.3d 37, 44, 145 Cal.Rptr. 380, 577 P.2d 200; *Glaire v. La Lanne–Paris Health Spa, Inc.* (1974) 12 Cal.3d 915, 927, 117 Cal.Rptr. 541, 528 P.2d 357.)

No one claims the contractual provision at issue in the case at bar is a loan; rather, the corporate and individual defendants (collectively Gosh) contend the provision is a forbearance. It is not. Neither the Constitution nor the statute defines "forbearance," but the term has a settled meaning: as the majority again correctly observe, "A forbearance of money is the giving of further time for the payment of a debt or an agreement not to enforce a claim at its due date." (Maj. opn., *ante,* p. 406 of 274 Cal.Rptr., p. 1249 of 798 P.2d.) These acts, of course, are complementary—two sides of the same coin: there is forbearance when, *at the time a debt matures,* the creditor (1) agrees to refrain ("forbear") from enforcing the debt immediately, and instead (2) agrees to give the debtor additional time to pay. Whatever the motives of the parties, the essence of the transaction is thus the voluntary *agreement* of the creditor to a new maturity date for the debt. [2]

It is not difficult to apply this definition to the undisputed facts before us. Each delivery ticket and invoice for the goods sold bore the notation that "It is understood and agreed to pay carrying charges of 1 ½% per month (18% per annum) on any balance unpaid after the 10th of the following month of the date of purchase." But it was Gosh, the purchaser, that "understood and agreed" to pay such charges. The seller, Southwest Concrete Products (Southwest), did not agree to anything; in particular, it did not agree, on each maturity date, that it would refrain from enforcing the debt and that Gosh could have extra time to pay. On the contrary, South ***711** west filed this action for the very purpose of collecting the

amounts due on the dates specified in the delivery tickets and invoices, together with the late charges. Thus Southwest not only did not expressly agree to forbear, but an implied agreement to that effect is foreclosed both by the terms of the contract and by Southwest's conduct in filing this action. The provision for late charges was therefore not a forbearance.

As the majority correctly note, this conclusion is underscored by contemplating its opposite: as pointed out in *O'Connor v. Televideo System, Inc.* (1990) 218 Cal.App.3d 709, 717, 267 Cal.Rptr. 237, "If the invoice[s] truly constituted an agreement to give further time for payment in exchange for an 18 percent surcharge on the principal, then the buyer could conceivably forbear ad infinitem, so long as the finance charge was paid, and the creditor could never recover the principal. The creditor would never be able to sue to collect the money past due because it was receiving consideration for its agreement to forbear on the account." The reason why such a result would be intolerable is also obvious: in the real world a seller of goods often operates on a narrow profit margin; unless ****1254 ***411** he is paid for his product within a reasonable time, he will be unable to meet his own costs and his business will be in jeopardy. He cannot, in short, live by late charges alone.

It follows that the contractual provision here in issue was neither a loan nor a forbearance. As the majority correctly hold, it was therefore "not subject to the usury law." (Maj. opn., *ante,* p. 406 of 274 Cal.Rptr., p. 1249 of 798 P.2d.)

II

The majority nevertheless go further, and hold that two "exceptions" to the usury law are applicable in this case—the time-price doctrine and the rule that a debtor cannot make a valid contract usurious by his voluntary act. (Maj. opn., *ante,* pp. 407–409 of 274 Cal.Rptr., pp. 1250–1252 of 798 P.2d.) Neither of the latter holdings is necessary to our decision, because the majority's principal holding that the contractual provision was not a forbearance fully disposes of the claim that it violated the usury law. Worse, each of these secondary holdings is incorrect.

The majority first declare that the contractual provision is exempt from the usury law under the time-price doctrine. (Maj.opn., *ante,* p. 407 of 274 Cal.Rptr., p. 1250 of 798 P.2d.) For several reasons, that doctrine has nothing to do with the case at bar. Although their opinion is unclear and conclusory on this point, the majority appear to reason as follows: (1) the time-price ***712** doctrine "applies when property is sold on credit" (maj. opn., *ante,* p. 407 of 274 Cal.Rptr., p. 1250 of 798 P.2d); (2) "The transaction in this case was a credit sale" (*id.* at p. 408 of 274 Cal.Rptr., at p. 1251 of 798 P.2d); and therefore (3) the time-price doctrine applies to the transaction in this case. The conclusion does not follow, however, because the term "credit sale" has a different meaning in each of the majority's two premises.

In the first premise "credit sale" means, as the majority correctly state, a sale in which "the seller finances the purchase of property by extending payments over time and charging a higher price for carrying the financing." (Maj. opn., *ante,* p. 407 of 274 Cal.Rptr., p. 1250 of 798 P.2d.) This is the typical retail installment sale contract. [3] It is true, as the majority point out, that if such a transaction is bona fide it "is not subject to the usury law because it does not involve a loan or forbearance." (*Ibid.*) But that fact is irrelevant, because the case at bar does not involve such a contract.

In a retail installment sale contract the seller agrees to let the buyer pay for the goods in a number of partial payments spread over a predetermined period of time, rather than immediately in a lump sum, and charges a higher price to compensate for his loss of the present use of the buyer's money, the risk of default, the effect of inflation, etc. The transaction is thus distinguished by certain attributes. First, the seller in effect offers the goods at two prices—one price if the buyer pays cash and a higher price if he purchases on credit. Second, if the buyer opts to purchase on credit, the parties agree to all the terms of the sale—including the ultimate price—at the outset, before either begins to perform. Third, each payment is, in its entirety, a portion of the agreed price, even though part of the payment may be characterized as "interest" (or "service charge" or "finance charge," etc.). Fourth, as long as the buyer makes each payment in the agreed amount and on time, he is not in default. The time-price doctrine applies to such a transaction, and provides that the difference between the cash price and the credit or "time" price—called "the time ****1255** - *****412** price differential"—is not interest and hence is not subject to the usury law.

None of these four attributes, however, is shared by the kind of "credit sale" referred to in the majority's second premise and actually at issue in this case. In such a transaction the seller requires that the buyer pay him the full price of the goods in a lump sum within a specified time—usually a

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***713** matter of days—after delivery; to encourage timely payment, the contract also imposes a late charge in the event of default. Although such a transaction is in theory a species of installment sale, it may more accurately be denominated a "single-payment credit sale," and is used primarily by manufacturers and wholesalers such as Southwest.

A single-payment credit sale differs from the typical retail installment sale contract in each of the four ways discussed above. First, Southwest did not offer to sell its goods to Gosh at one price for cash and another on credit, and hence there was no time-price differential. There was only one price offered and accepted. Second, Southwest did not agree at the inception of the sale that the late charge of 1 ½ percent per month would be part of the credit price of the goods; instead, as the Court of Appeal correctly observed in its opinion below, "Southwest did not intend to extend credit but rather imposed the finance charge to encourage payment within the specified time, and to compensate it for the delay in payment." Third, for this reason the late charge did not become part of the sale price even after it was incurred. And fourth, even if it had paid the late charge, Gosh would have been in default because it failed to pay the sale price on the specified date: under this contract, Gosh did not have the option of avoiding default simply by adding 1 ½ percent to the price.

For present purposes, accordingly, a wholesaler's single-payment credit contract is a very different instrument from a retailer's installment sale contract. Because of those differences, the majority err in holding that the late charge here in issue is exempt from the usury law under the time-price doctrine, which applies only to the latter type of contract.

III

The majority also hold the present contractual provision exempt from the usury law under "the rule that a transaction that was not usurious at its inception cannot become usurious by virtue of the *debtor's* voluntary default." (Maj. opn., *ante,* p. 409 of 274 Cal.Rptr., p. 1252 of 798 P.2d), italics added.) The emphasized word underscores the real purpose of this "rule," and in so doing shows its irrelevance to the case at bar. [4]

The purpose of the debtor's act rule is to prevent injustice in the following circumstances: (1) a lender (creditor) makes a loan that bears a stated interest rate at a legal level; (2) the terms of the loan include a contingency ***714** which, if it occurs, will result in an effective interest rate above the legal level; and (3) the contingency is within the control of the borrower (debtor). The courts recognize that it would be inequitable to allow the borrower *by his own conduct* to deprive the lender of the benefit of his loan or subject him to the civil and criminal penalties of the usury law. To prevent this result the courts have long enforced the rule that "The agreement must, in its inception, be usurious, for it cannot become so by reason of the borrower's default. (*Sharp v. Mortgage Security Corp.* [(1932)] 215 Cal. 287 [9 P.2d 819].) Where the excessive interest is caused by a contingency under the lender's control, or not under the borrower's control, the transaction is usurious; [it is] *otherwise when the contingency is under the borrower's control.*" (*Penziner v. West American Finance Co.* (1933) 133 Cal.App. 578, 590, 24 P.2d 501, italics added.) Some examples will illustrate the proper application of this rule.

Perhaps the most common contingency within the borrower's control is his voluntary default. A loan agreement may provide the maximum legal rate of interest ****1256** *****413** plus additional charges if the borrower defaults. Even if these charges are measured by or characterized as "interest," they do not make the transaction usurious: "Usury law applies only to unmatured contracts with a fixed obligation. If the borrower can avoid the liability of a default payment by the performance of the contract, this extra cost is not regarded as interest, but rather a means of enforcing punctual payment. The contingency of these charges is technically within the borrower's control." (Note, *A Comprehensive View of California Usury Law* (1974) 6 Sw.U.L.Rev. 166, 212 (hereafter *California Usury Law*).)

For example, in *First American Title Ins. & Trust Co. v. Cook* (1970) 12 Cal.App.3d 592, 596–597, 90 Cal.Rptr. 645, a loan agreement bearing the maximum legal interest rate also provided that if the borrower failed to pay such interest it would be added to the principal and thereafter itself bear interest at the same rate, i.e., compound interest. The court rejected the borrower's claim that the latter provision made the agreement usurious: "Whether a transaction is usurious must be determined as of the time of the transaction. An agreement which is not usurious in its inception cannot become so by reason of the borrower's subsequent default. [Citations.] The penalty provisions to which [the borrower] now objects come into play only in the event of his default. Such payments are not regarded as interest on the loan itself, but as a penalty for nonperformance of a legitimate agreement." (Accord, *Penzner v. Foster* (1959) 170 Cal.App.2d 106, 109–110, 338

P.2d 533, and cases cited.) In short, "It would be [inequitable to] the lender to permit a borrower to transform a legal loan into a usurious one simply by ***715** defaulting on his interest payments." (Note, *California Usury Law, supra,* 6 Sw.U.L.Rev. at p. 213.)

Another contingency within the borrower's control is his exercise of a prepayment option. A loan agreement may provide the maximum legal rate of interest plus an additional charge if the borrower elects to repay all or part of the principal before it is due. Although the charge is often calculated in terms of extra days—commonly 180—of "unearned interest," it does not make the transaction usurious: "The courts have allowed the lender to assess a premium because the prepayment of the loan and its concurrent penalty rest entirely within the borrower's control; he need not exercise his option." (Note, *California Usury Law, supra,* 6 Sw.U.L.Rev. at p. 204.)

For example, in *French v. Mortgage Guarantee Co.* (1940) 16 Cal.2d 26, 104 P.2d 655, a loan agreement bearing the maximum legal interest rate also allowed the borrower to prepay his obligation upon giving the lender timely notice and "a sum of money equal to 90 days' unearned interest on the then unpaid principal as a bonus for such prepayment privilege." (*Id.* at pp. 27–28, 104 P.2d 655.) The court rejected the borrowers' claim that the latter provision made the agreement usurious: "the allegedly excessive interest collected was brought about by the voluntary act of [the borrowers] in exercising the prepayment option. The rule is that in such circumstances the transaction is not thereby made usurious." (*Id.* at p. 31, 104 P.2d 655.) The court drew an analogy to cases of a borrower's voluntary default, reasoning that " 'there is still no usury, unless we hold that a ... contract nonusurious if complied with by the debtor, may be rendered by him usurious and illegal by his voluntary default in respect thereto. That a debtor cannot so bring his creditor under heavy penalties is too clear to admit of discussion' " (*id.* at p. 33, 104 P.2d 655; accord, *Abbot v. Stevens* (1955) 133 Cal.App.2d 242, 247–249, 284 P.2d 159).

A final example of a contingency within the borrower's control is a loan agreement bearing the maximum legal interest rate and providing that the principal amount of the loan is not to be disbursed to the borrower in a lump sum at the outset, but over time in installments. Such agreements are often used in construction loans, with the proceeds being paid out as the building progresses. Whether the agreement is usurious depends on who controls the disbursement: " 'the mere fact that the whole sum loaned is not drawn promptly by the borrower does not render the loan usurious, provided the whole sum was held subject to the borrower's order....' If the ****1257** *****414** agreement contemplates that the entire loan shall be available to the borrower, mere delay in its payment to him, in the absence of intent to evade the Usury Law, does not make the loan usurious, but if, as a condition of the loan the borrower is *required* to leave part with the lender, interest in ***716** excess of the legal rate on the sum actually available is usurious." (*Penziner v. West American Finance Co., supra,* 133 Cal.App. 578, 590, 24 P.2d 501, italics added.)

By contrast, the contractual provision now before us is—as the majority correctly hold—neither a loan nor a forbearance to enforce a loan; it is an ordinary single-payment credit sale of goods by a wholesaler. There is therefore no risk that any borrower will deprive any lender of the interest on his loan or subject him to the penalties of the usury law. Indeed, there is no borrower at all, no lender, and no interest—less still usurious interest. It follows that there is neither need nor occasion in this case to invoke the debtor's act rule, and the majority err in doing so. [5]

IV

Finally, I am troubled by an unanswered question in this case. The trial court awarded the late charges to Southwest as "prejudgment interest" (see Civ.Code, § 3289, subd. (a)), and the Court of Appeal sustained that award. But because these charges—as the majority correctly hold—are not "interest" of any kind, they are not "prejudgment interest" either. Then what are they? Southwest contended in the Court of Appeal that they are valid liquidated damages, and amicus curiae makes the same contention in this court. (See Loomis, *Crestwood Lumber Company v. Citizens Savings & Loan Association: The Usury Law and Liquidated Damages in Sale of Goods Transactions* (1980) 10 Golden Gate L.Rev. 553.) The majority decline to reach the question because of "our limitation of review to the issue of usury" (maj. opn., *ante,* p. 409 of 274 Cal.Rptr., p. 1252 of 798 P.2d). I do not agree that our order limiting review prevents us from reaching this question: in my view the question is "fairly included," within the meaning of rule 29.2(b) of the California Rules of Court, in the larger issue of usury set forth in our order.

I reluctantly agree, however, that we must leave this question unanswered for the time being. I do so because the parties have neither briefed ***717** nor argued the difficult problems

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that will arise in any attempt to give a definitive answer on this point. Two questions in particular need to be addressed. First, is this case governed by the liquidated damages statute (Civ.Code, § 1671) or by the special statute dealing with breach of an obligation to pay a liquidated sum (Civ.Code, § 3302)?[6] Second, what is the effect on this question of the provisions of the California Uniform Commercial Code? Until such questions are fully litigated, this effort to clarify the law of usury must regrettably remain incomplete.

BROUSSARD, J., concurs.

All Citations

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Footnotes

1 Subdivision (2) of that provision sets the maximum rate at the higher of 10 percent or 5 percent per year plus the Federal Reserve Bank of San Francisco rate in effect on specified dates. (Cal. Const., art. XV, § 1, subd. (2).)

It is undisputed that the maximum permissible rate is less than 18 percent per year.

2 Even more recently, however, the Sixth Appellate District Court of Appeal criticized and refused to follow *Crestwood* and *Mark McDowell* in *O'Connor v. Televideo System, Inc., supra,* 218 Cal.App.3d 709, 267 Cal.Rptr. 237.

3 The Court of Appeal did not discuss *Mark McDowell Corp. v. LSM 128, supra,* 214 Cal.App.3d 1427, 263 Cal.Rptr. 310, because that case was filed a few weeks after the opinion in this case.

4 The Unruh Act (Civ.Code, §§ 1801–1812.20) was adopted in 1959 to regulate retail installment sales. It regulates, among other things, the finance charges that may be collected for bona fide credit sales of consumer goods or services. It applies, however, only to retail transactions.

1 Our statutory usury law, an initiative measure that has not been codified (Stats.1919, p. lxxxiii (10 West's Ann.Civ.Code (1985 ed.) foll. § 1916.12 at p. 148)), likewise applies only to a "loan or forbearance." Although not mentioned by the majority, this statute remains in full force and effect to the extent that it does not conflict with the Constitution, e.g., in its provisions for civil and criminal penalties. (*Penziner v. West American Finance Co.* (1937) 10 Cal.2d 160, 170–178, 74 P.2d 252.)

2 Indeed, this is presumably why the drafters included the term "forbearance" in the usury law: a forbearance is sufficiently like the act of making a new loan that to omit it would allow evasion of the interest limitations on the prime target of the usury law, i.e., loans as such.

3 Common examples are a contract for the sale of real property in which the vendor retains legal title and the purchaser makes a downpayment followed by agreed periodic payments of principal and interest (*Verbeck v. Clymer* (1927) 202 Cal. 557, 562–563, 261 P. 1017), and a contract for the retail sale of a "big ticket" item of personal property (e.g., an automobile or a major household appliance) on similar terms. A special category of the latter type of contract is the "revolving" retail charge account, in which the buyer has the option of making continuing credit purchases upon payment each month of a minimum installment and a finance charge, both calculated on the unpaid balance. (*Fox v. Federated Department Stores, Inc.* (1979) 94 Cal.App.3d 867, 875–882, 156 Cal.Rptr. 893.)

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4 As will appear, the “rule” is more a statement of policy than a substantive principle. For purposes of convenience, however, I shall refer to it hereafter as the debtor's act rule.

5 Two decisions of the Court of Appeal have fallen into the same error. In *Fox v. Federated Department Stores, Inc., supra,* 94 Cal.App.3d 867, 884, 156 Cal.Rptr. 893, the court correctly held that a “nonrevolving” retail charge account, in which payment in full is due within 25 days of receipt of the monthly statement, is not subject to the usury law. The court correctly reasoned that the finance charges of 1 ½ percent per month assessed on default “are not interest” (*ibid.*), explaining elsewhere in its opinion that the transaction was a sale rather than a loan or forbearance. Unfortunately the court also relied—erroneously and unnecessarily—on both the time-price doctrine and the debtor's act rule. *(Ibid.)*

In *O'Connor v. Televideo System, Inc., supra,* 218 Cal.App.3d 709, 716, 267 Cal.Rptr. 237, the court correctly held that a single-payment credit sale of goods by a wholesaler—the issue before us now—is not subject to the usury law. The court correctly reasoned that such a transaction is not a forbearance (*id.* at p. 717, 267 Cal.Rptr. 237), but it also relied—erroneously and unnecessarily—on the debtor's act rule (*id.* at pp. 716–717, 267 Cal.Rptr. 237).

6 Civil Code section 3302 provides that “The detriment caused by the breach of an obligation to pay money only, is deemed to be the amount due by the terms of the obligation, with interest thereon.”

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257 Cal.App.2d 485
Court of Appeal, First District, Division 4, California.

BARUCH INVESTMENT COMPANY, doing business as Advance Industrial Finance Co., Plaintiff and Appellant,
v.
LaVerne Moore HUNTOON et al., Defendants and Respondents.

Civ. 24192.
|
Dec. 27, 1967.
|
Hearing Denied Feb. 21, 1968.

Synopsis

Action by plaintiff investment company for recovery for breach of an agreement under which defendant used its accounts receivable in order to obtain working capital. Defendant cross-complained for usury. The Superior Court, County of Los Angeles, John Stuart Frazer, J., entered judgment denying plaintiff recovery and awarding defendant damages on its cross complaint, and plaintiff appealed. The Court of Appeal, Christian, J., held, inter alia, that evidence sustained trial court's finding that accounts receivable financing transaction wherein account owners guarantee repayment of sums advanced within a specified period under factoring agreement and also were granted right to repurchase accounts in default for full amount of each invoice constituted a 'loan' subject to usury laws, and not a 'sale'.

Judgment affirmed.

Attorneys and Law Firms

***487** ****133** Leland, Hoffman & Kalik, by N. Stanley Leland and Sherman A. Silverman, Beverly Hills, for appellant.

Paul Barksdale d'Orr, Henry H. Angell, Los Angeles, for respondents.

Opinion

CHRISTIAN, Associate Justice.

Plaintiff Baruch Investment Company appeals from a judgment which denied it recovery for breach of an agreement under which respondent Huntoon Engineering (hereinafter Engineering) used its accounts receivable in order to obtain working capital. The court also awarded Engineering $42,951.02 damages on its cross-complaint for usury.

Donald Huntoon and LaVerne Huntoon, husband and wife, were president and secretary respectively of Engineering. In April 1961, the firm was profitably engaged in sub-contracting work on a number of government projects but, due to internal litigation, it was unable to obtain money from banks to finance its operations. Cash in the amount of $150,000 was needed to meet immediate obligations, and Mr. Huntoon therefore approached Jack Baruch, president of appellant Baruch Investment Company, with a request to raise the money. Engineering had accounts receivable of greater value than the amount of cash needed. Huntoon testified that Baruch offered to advance 40 per cent of the value of the accounts for a period of 45 days if Huntoon would assign the accounts so that Baruch could collect them. Huntoon rejected this idea as he did not want his customers to be contacted by any third party. Later in the discussion Baruch offered to ***488** advance 65 per cent of the value of the accounts upon the understandings that no notice of any assignment would be given to the customers and that Huntoon would collect the accounts and remit the proceeds to Baruch from time to time. The accounts were to be subject to a further discount of 1 1/2 per cent of their face value for each 45 days of delinquency. This general plan was agreed to orally.

Baruch then presented a printed form of 'factoring agreement,' stating, 'this is only a formality,' and Huntoon signed it. A personal guaranty was signed by Mr. and Mrs. Huntoon. Upon that guaranty, appellant originally brought this action. Baruch also made up a schedule listing the affected invoices and gave Huntoon a printed form letter, signed by Baruch, granting Engineering the option to repurchase all accounts which had not been paid in full by the purchasers within 90 days from the date of purchase. That letter continued:

'You will pay to us, upon the exercise of said option, the full amount of each invoice which we shall have purchased from you and which you are repurchasing. This option is granted to you so that you may prevent our undertaking legal action or other action to enforce collection of said accounts which shall not be paid within sixty days from the date of our purchase of said invoices.'

The word 'sixty' was crossed out and 'ninety' substituted only the first time the figure appears. The change was

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made because Huntoon told Baruch that the 45-day period previously mentioned and the 60-day period were both too short, as the accounts might be paid more slowly.

Baruch kept neither the invoices nor the contracts between Engineering and its debtors, but he did keep copies of the invoices. Huntoon received an advance of $149,423.20 in this first transaction. On November 30, 1961, Huntoon informed Baruch that he needed more money but had no more invoices. Baruch replied that he could 'adjust' the accounts to enable him to make a further advance. Further advances were in fact made. Substantial payments were thereafter made by respondent, but a running balance of obligation continued.

On June 29, 1961, Mrs. Huntoon went to Baruch and requested more money. At that time Baruch had been paid only $5,000 on the first schedule and that was paid out of Engineering's own funds. Baruch then prepared a second schedule from which he discounted $8,914.17, or 3 per cent of the gross face value of accounts receivable ($297,139.11). But an additional $6,565.59 discount ****134** was taken, which represented ***489** 1 1/2 per cent interest every 45 days on the unpaid balance of the accounts listed on the first schedule.

Huntoon met with Baruch again on July 12, 1963, when Baruch summoned Huntoon into his office and demanded faster payment. Baruch announced that Engineering owed $84,407.53 and that the amount would increase at the rate of $56.27 per day. Baruch offered to settle for $50,000 or for $40,000 in cash that day. When Huntoon replied he did not have that such money, Baruch threatened to sue. Huntoon pleaded that he could not afford to pay such a high rate of interest, but Baruch replied that he could not grant any relief.

Between April 1961 and July 1963 eleven different schedules readjusting the transaction had been prepared by Baruch and signed by one or the other of the Huntoons. On at least five occasions LaVerne Huntoon signed letters authorizing appellant to discount the gross amount of invoices listed on certain schedules by specific sums and to withhold a reserve of 30 per cent. This was done both to induce appellant to make further advances and to obtain its forbearance from taking action to collect the accounts already assigned. Each of these letters recites that the authority granted is at variance with the 'factoring agreement.'

Baruch explained that in each instance he calculated the discount on the basis of the past performance of the debtors in making payments. He admitted that he deviated from the factoring agreement by taking larger discounts than it called for. He also admitted that he discounted from the same unpaid balance on several successive schedules at 3 per cent each time and that the amounts which Mrs. Huntoon authorized Baruch to discount were derived from his computations. He denied taking the unpaid balance of accounts receivable from former schedules and rediscounting for every 45-day period during which the accounts remained unpaid.

The contrary was demonstrated in the case of one $7,523.54 discount, authorized in a letter of September 12, 1961, which agreed to that amount of discount from 'schedule four.' Schedule four gives $7,523.54 as 'Our Disc(ount).' The gross amount of that schedule was $84,947.56. Three per cent of that figure is only $2,548.13. But taking the unpaid balance from schedule three and rediscounting it 3 per cent the exact amount, $7,523.54, may be derived. There was evidence that other amounts discounted were calculated in that manner by Baruch and specifically that the discount on schedule four ***490** contained rediscounts carried forward from unpaid balances on the invoices listed on schedules two and three.

Baruch testified that the 'reserve account,' referred to above, was to be withheld by him until the full amount of the accounts receivable had been paid to appellant. Then the balance in the reserve account was to be paid over to Engineering.

The trial court found that the transaction was an open loan account masquerading as a sale of accounts, which enabled appellant to procure compensation in excess of the lawful 10 per cent per annum for the use and forbearance of money. The assignment of the invoices and evidences of debt was found to constitute a pledge for security; thus the court concluded that appellant's rights terminated when Engineering repaid all sums advanced with the lawful amount of interest.

The total amount advanced by appellant to Engineering, $615,810.06, was paid. Interest at the rate of 10 per cent on all balances while they remained unapid amounted to $11,887.55. Finding that interest in the amount of $42,951.02 was actually paid, the court awarded damages in that amount on the cross-complaint for usury. No contention is advanced by appellant as to the measure of damages. When usurious interest has been exacted the debtor is entitled to recover treble the interest paid if he sues within one year (Deering's Gen.Laws (1918) Act 3757, s 3; Stats. 1919, p. lxxxiii, West's Ann.Civ.Code, s 1916—1 et seq.) or the bare amount of all interest paid if suit ****135** is brought within two years (as in the present case). (Taylor v. Budd (1933) 217 Cal. 262, 266, 18 P.2d 333.)

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On appeal it is contended that California Constitution, article XX, section 22, violates the equal protection clause of the United States Constitution. Article XX, section 22, adopted in 1934, provides that the rate of interest upon any loan shall be 7 per cent per annum; but it is provided that parties may contract in writing for a rate not exceeding 10 per cent. The section continues: 'No person * * * or corporation shall be charging any fee, bonus, commission, discount or other compensation receive from a borrower more than 10 percent per annum * * *.' The third paragraph states that these restrictions do not apply to certain financial institutions, but it is provided that the Legislature may prescribe regulations and maximum rates of interest for the exempted classes. This section in part superseded the Usury Law, an initiative measure adopted in 1918, in which a lawful rate of 7 per cent per annum was set, with the right to contract for a maximum ***491** rate of 12 per cent. (Deering's Gen.Laws (1918) Act 3757, West's Ann.Civ.Code, s 1916—1 et seq.) Section 3 of the Usury Law, West's Ann.Civ.Code, s 1916—3 created a right to recover treble damages from any person who receives an unlawful rate of interest, if suit is brought within one year of payment. The statute also makes it a misdemeanor to exact unlawful interest in certain situations.

Appellant relies principally upon the dissenting opinion of Mr. Justice Carter in Carter v. Seaboard Finance Co. (1949) 33 Cal.2d 564, 588—590, 203 P.2d 758. [1] In Carter it was asserted that the Personal Property Brokers Act of 1939 (an act by which the Legislature exercised the authority granted it by article XX, section 22, to regulate one of the exempt classes of lenders) unconstitutionally discriminated against personal property brokers loaning less than $300, because a maximum rate was fixed only for small loans. The court rejected this argument, stating:

'The federal equal protection clause does not prevent the legislature from classifying loans according to size. It has long been recognized that in general borrowers of large sums are better able to protect themselves against excessive charges than small borrowers. * * * But under the plan contemplated by the constitutional amendment the legislature was expected to enact legislation with respect to the exempt classes whenever the necessity should arise. Because it has found such a necessity with regard to some exempt lenders and not others, does not affect the validity of the plan under the federal Constitution. The legislature may proceed with deliberateness to strike at abuses wherever they appear and need not formulate simultaneous regulation for all the exempted groups.' (33 Cal.2d at 588, 203 P.2d at 773, emphasis added.) That holding disposes of the constitutional attack upon article XX, section 22.

Appellant also asserts that the treble damages and misdemeanor provisions of the Usury Law (neither of which is involved in the present case) discriminate by penalizing some classes, but not others, for identical acts. But appellant lacks standing to attack the constitutionality of the Usury Law. A court will not consider the constitutionality of a statute ***492** at the request of a person against whom no attempt has been made to enforce the ****136** statute. (Stephenson v. Binford (1932) 287 U.S. 251, 277—278, 53 S.Ct. 181, 77 L.Ed. 288; 16 Am.Jur.2d, Constitutional Law, ss 119—122, pp. 310—318.) 'The controlling question is whether the appellant 'has sustained or is immediately in danger of sustaining some direct injury as the result of (the statute's) enforcement * * *.' Com. of Massachusetts v. Mellon, 262 U.S. 447, 488, 43 S.Ct. 597, 67 L.Ed. 1078.' (Cramp v. Bd. of Public Instruction (1961) 368 U.S. 278, 282—283, 82 S.Ct. 275, 278, 7 L.Ed.2d 285.)

Appellant's attack upon the findings of the trial court may be summarized as follows: the trial court looked only at the final result of the transactions, determined that the discounts exceeded 10 per cent per annum upon the amounts advanced to respondents, and ignored the asserted fact that appellant merely used normal and logical business methods in arriving at the amounts of the discounts. Appellant insists that the signed, printed form of factoring agreement is controlling, and cites us to several items of evidence suggesting that the transaction might have been a series of sales.

Accounts receivable financing is an uncertain area in the usury law and no exact tests have been formulated. The question whether a transaction is a sale or a usurious loan is one of fact and the trier of fact should look to substance rather than to form. (Thomas v. Hunt Manufacturing Corp. (1954) 42 Cal.2d 734, 740, 269 P.2d 12; Wooton v. Coerber (1963) 213 Cal.App.2d 142, 145, 28 Cal.Rptr. 635.) We must determine whether there is any substantial evidence to support the findings and, where a finding of either a loan or a sale can be inferred from the facts, we may not substitute our judgment for that of the trial court. (Wooton v. Coerber, supra; Whittemore Homes, Inc. v. Fleishman (1961) 190 Cal.App.2d 554, 559, 12 Cal.Rptr. 235.) The appellant must demonstrate the insufficiency of the evidence. (Valdez v. Clark (1959) 173 Cal.App.2d 476, 479, 343 P.2d 281.)

Appellant insists that the printed form of factoring agreement and the contemporaneously executed documents embody the contract. The trial court, however, found that the factoring

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agreement was amended and its terms waived by Baruch. It was not disputed that Baruch constantly deviated from the factoring agreement. It is claimed that the agreement of Advance not to notify Engineering's debtors of the assignment and not to collect directly from them does not make a ***493** transaction a loan. A loan may be found even if the 'buyer' gives notice and collects the debts. (Milana v. Credit Discount Co. (1945) 27 Cal.2d 335, 342, 163 P.2d 869, 165 A.L.R. 621.) But notice of assignment and collection by the 'buyer' are evidentiary factors for the trier of fact to consider in making its determination. Notification normally indicates a sale, and non-notification normally indicates a loan. (See note: Accounts Receivable Financing, 14 Stan.L.Rev. 520, fn. 6 (May 1962).)

Appellant asserts that there is no evidence to show that Engineering was obligated to repay money paid by appellant to respondents. But paragraph 2(d) of the 'factoring agreement' provided that '(Engineering) guarantees the payment of all Accounts receivable purchased hereunder to the extent of the amount paid therefor by (appellant).' Respondents D. W. and LaVerne Huntoon personally guaranteed full and faithful performance of that agreement. The court was also entitled to consider the fact that once respondents were involved with appellant, they began to sink into a bog of ever more crippling discounts more characteristic of an undesirable type of loan business than of accounts receivable financing. It is also significant that when the accounts were slow in paying appellant did not elect to proceed against the debtors whose accounts had supposedly been purchased. Instead, appellant badgered the Huntoons, indicating that they, and Engineering, were regarded all along as the debtors.

****137** Appellant points to Advance Industrial Finance Co. v. Western Equities, Inc. (1959) 173 Cal.App.2d 420, 343 P.2d 408, and Refinance Corp. v. Northern Lumber Sales, Inc. (1958) 163 Cal.App.2d 73, 78, 329 P.2d 109, as cases where similar 'factoring agreements' have been upheld. In Advance, the intent to sell accounts rather than use them as security for a loan appeared on the face of the contract; the court stated that Milana did not establish that a contract for purchasing receivables is, per se, a loan. (173 Cal.App.2d at 429, 343 P.2d 408.) But there the 'factoring agreement' (apparently identical with the printed form used in this case) was unmodified; the facts are distinguishable in other ways as well.

In Milana v. Credit Discount Co., supra, 27 Cal.2d 339, 163 P.2d 869, plaintiff required funds immediately to operate her established business and meet payrolls. Defendant offered to render financial assistance, through a 'sales agreement,' by buying all of plaintiff's accounts in separate schedules at face value, less any customer's discount, less an additional 2 per cent discount. ***494** Plaintiff was to receive 85 per cent of the face value upon assignment and the balance, less discounts, was to be held in a reserve account for payment to plaintiff after all the accounts listed on the schedules were paid in full. Plaintiff unconditionally guaranteed to pay every account within 60 days after assignment. In practice, accounts not so paid were returned to plaintiff and 'repurchased' by defendant, who took an additional discount. Later, the discount rate was raised to 2 1/2 per cent. Plaintiff gave notices of assignment to her customers and was obligated to transfer all collections to defendant in their original form as cash or checks. After reciting the factors to be weighed in determining whether a loan exists, the Supreme Court held that by the contracts and actual practice defendant had secured itself against loss and protected a return of 2 to 2 1/2 per cent every 60 days. (27 Cal.2d at 340, 163 P.2d 869.) In all the circumstances, the court found indications that the parties had provided for a 'conditional transfer of title; that advances by the defendants were contemplated to be repaid within a specified time at a charge for the use of the money which was deducted in advance * * * the transactions were not sales of accounts receivable but loans secured by assignment of the accounts at usurious rates of interest * * *.' (27 Cal.2d at 341—342, 163 P.2d at 872.) The court observed that while continued collection of accounts by the seller (as in the instant case) would have been a factor indicating a loan, a more significant fact was that had defendant taken absolute title there would be no need to guarantee payment within specified periods or to repurchase the accounts. The guarantys were held to amount to promises to repay money loaned at a usurious rate.

Here respondents, similarly in immediate need of financing, guaranteed repayment of sums advanced within a specified period under the 'factoring agreement' and also were granted the right to 'repurchase' accounts in default for the full amount of each invoice. The court found that, in practice, defaulted accounts were subjected to additional interest through the device of carrying them forward and rediscounting them, a device similar to the 'repurchasing' in Milana. The present case indeed presents stronger indications of usury than Milana since there notification was given to the debtors.

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In Refinance Corp. v. Northern Lumber Sales, Inc., supra, 163 Cal.App.2d 73, 329 P.2d 109, the other case principally relied on by appellant, the plaintiff agreed to purchase all accounts Without ***495** recourse provided plaintiff first approved the debtor's credit. If there was no approval, the purchase was with recourse, but defendant would have the account returned upon the customer's default. The court, after quoting extensively from Milana, found that ****138** there was no loan and no guaranty of repayment of the purchase price. The court stated that the giving of a guaranty is simply an item of evidence to be considered by the trial court and that there was substantial evidence to support the trial court's finding of a sale. Here the trial court reached a contrary result, on evidence which we regard as sufficient.

Appellant next contends that if the transaction was a loan, there were ten separate loans and all but the last three occurred more than two years before the action was commenced and hence recovery is barred by Code of Civil Procedure, section 339, subdivision 1. Appellant argues that Engineering's obligation to repay the amounts loaned arose immediately when the money was advanced, presumably because at that time the 'discount' was entered on the schedules. But an action for money had and received could not be brought before any money was transferred to appellant from respondent. Until the borrower has paid interest in excess of the lawful rate he may not maintain an action to recover usurious interest against the lender. (Weiss v. Brandt (1955) 137 Cal.App.2d 710, 719, 290 P.2d 626.) Where there is no written agreement as to the allocation of payments between principal and interest, such an agreement may be proved by parol. But all payments will be applied to reducing the principal unless there is an express agreement to apply them to interest or an actual application to interest by the creditor. In Weiss, 65 separate assignments of purchase orders were held to be one transaction because it was demonstrated that several of the assignments were tied into one by 'charge backs' on earlier orders to later orders. Since there was but a single loan all payments were allocated to principal as a matter of law.

Appellant asserts that here there was an actual application of payments to interest since appellant paid itself the discounts from the accounts. Actually, the record shows that the money which appellant received from collection of accounts, or from Engineering, was entered on the schedules by means of credit memoranda, which reduced the face value of the accounts listed on the schedules. There was no readjustment of the discounts, which the court found to represent ***496** interest. Therefore the cross-complaint was not barred by the statute.

Appellant pleaded as a defense to the cross-complaint a document, signed on June 28, 1962 by LaVerne Huntoon, which purportedly released appellant from all claims of any kind, known or unknown, from the beginning of the world to the date of execution. The court below found, relating the circumstances in detail, that this release was procured 'only by the exercise of duress, coercion and illegal business compulsion, * * *' Appellant contends that the evidence is insufficient to support this finding on the ground that there was no competent evidence indicating the existence of overreaching. We need not consider this contention, as another finding is determinative of the issue: while the release was signed on June 28, 1961, the usurious interest was paid on July 24 and October 1, 1962. A 'voluntary' payment of excessive interest does not waive the usury laws, which are designed for the protection of society. (Stock v. Meek (1950) 35 Cal.2d 809, 817, 221 P.2d 15.) A fortiori a general waiver of rights, executed before usurious interest was paid, could not defeat the respondent's cross-complaint.

The judgment is affirmed.

DEVINE, P.J., and RATTIGAN, J., concur.

All Citations

257 Cal.App.2d 485, 65 Cal.Rptr. 131

Footnotes

1 Justice Carter, dissenting, would have held that the third paragraph of section 22, exempting certain types of lenders, violates the equal protection clause and is inoperative, 'at least until such time as the Legislature acts and makes a reasonable classification * * * for such excepted persons, and that such exception is severable from the balance of section 22, thus leaving in effect the first two paragraphs thereof which provide for a maximum rate of 10 per cent for all lenders.' (33 Cal.2d at 589, 203 P.2d at 773.)

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United States Bankruptcy Court, S.D. New York.

IN RE GREENWICH RETAIL GROUP LLC, Debtors.
Greenwich Retail Group LLC, Plaintiffs,
v.
Moby Capital, LLC, et al., Defendants

Case No. 25-11295 (MEW) (Jointly Administered)
|
Adv. Proc. No. 25-01106 (MEW)
|
Signed February 20, 2026

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DECISION ON PENDING MOTIONS TO DISMISS

HONORABLE MICHAEL E. WILES, UNITED STATES BANKRUPTCY JUDGE

***1** This adversary proceeding brought by Debtors Greenwich Retail Group LLC ("**GRG**") and Madison Westside LLC ("**Madison**") challenges the Debtors' obligations under agreements that the Debtors have characterized as "merchant cash advance" transactions. The Debtors have settled with some defendants, and some other defendants have filed answers. Four defendants have filed motions to dismiss. Defendant Itria Ventures LLC ("**Itria**") seeks the dismissal of all claims against it. Defendants Newco Capital Group VI LLC ("**Newco**"), Smart Business and Square Advance seek dismissal of some (but not all) of the asserted claims. The moving defendants are identified hereafter as the "Defendants."

The Court heard argument on December 10, 2025. With the Court's permission, Itria filed a supplemental memorandum on January 15, 2026, to address an issue that had been discussed during oral argument, and the Debtors filed a response on February 2, 2026.

For the reasons set forth below, the motions to dismiss are granted in part, with leave to replead some of the dismissed claims, and are otherwise denied.

The Amended Complaint and the Debtors' Later Concessions

The Amended Complaint asserts twenty-eight causes of action, though the numbering is confusing because two counts were each accidentally designated as Count V. Twenty-two of the stated causes of action have been asserted against one or more of the Defendants. The relevant counts in the Amended Complaint are:

- Count I, which seeks a declaration that "all liabilities" owed to the Defendants are void under New York's usury laws and that the amounts claimed by the Defendants should be negated;
- Count III, which contends that a confession of judgment in favor of Itria, as well as a New York state court judgment entered pursuant to that confession of judgment, are void based on fraud in the inducement, reservation of usurious interest, lack of consideration, and fraudulent transfer;
- Count IV, which asserts that the Debtors paid not less than $325,000 to Itria from and after July 29, 2024, and that such payments should be avoided and recovered based on alleged fraud in the inducement, reservation of usurious interest, lack of consideration, and fraudulent transfer;
- Count V (Newco), which asserts that the Debtors paid $152,861 to Newco from and after September 26, 2024, and that such payments should be avoided and recovered based on alleged fraud in the inducement, reservation of usurious interest, lack of consideration, and fraudulent transfer;

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- Count V (Square Advance), which asserts that the Debtors paid $99,509 to Square Advance from and after September 26, 2024, and that such payments should be avoided and recovered based on alleged fraud in the inducement, reservation of usurious interest, lack of consideration, and fraudulent transfer;

- Count VI, which asserts that the Debtors paid $54,252 to Smart Business from and after December 6, 2024, and that such payments should be avoided and recovered based on alleged fraud in the inducement, reservation of usurious interest, lack of consideration, and fraudulent transfer;

***2** • Count VIII, which contends that the Defendants are in possession of fraudulent transfers that they have not returned and that their claims should be disallowed under Section 502(d) of the Bankruptcy Code;

- Count IX, which seeks a declaratory judgment that the parties' contracts are governed by New York law;

- Count X, which seeks a declaration that the parties' contracts are unconscionable and are contracts of adhesion under New York law and should be declared void;

- Counts XI and XII, each of which seeks a declaration that the transactions with the Defendants are loan transactions;

- Counts XIII and XIV, which contend that the contracts with the Defendants are void due to impossibility and unconscionability and which also seek orders declaring the secured or unsecured status of the Defendants' claims and, if the Defendants' claims are secured claims, the relative priorities of the Defendants' secured claims in relation to the claims of other secured creditors;

- Count XV, which seeks an order equitably subordinating the claims of the Defendants to the claims of all other creditors;

- Count XVIII, which seeks an order disallowing the Defendants' claims pursuant to Section 502(b)(2) of the Bankruptcy Code on the ground, and to the extent, that the Defendants seek to recover "unmatured interest;"

- Count XIX, which contends that the Defendants are in possession of fraudulent transfers that they have not returned and that their claims should be disallowed under Section 502(d) of the Bankruptcy Code;

- Count XX, which seeks a declaration that the obligations owed to the Defendants are unenforceable under New York civil and criminal usury statutes;

- Counts XXI and XXII, each of which seeks an order extending the automatic stay to include Guarantors of the Debtors' obligations under the contracts with the Defendants;

- Count XXIII, which asserts that if the Court determines that the underlying transactions are purchases of receivables, and not loans, that the Court should then approve the rejection of the contracts pursuant to Section 365(a) of the Bankruptcy Code;

- Count XXVII, which alleges that the contracts with the Defendants are void due to fraud in the inducement and on fraudulent transfer grounds; and

- Count XXVII, which contends that the Defendants have acted inequitably and that their claims should be equitably subordinated.

There is significant overlap or outright duplication in the asserted claims. Some of the counts also lump several theories together, contending (for example) that certain results should be reached on the grounds of fraud in the inducement, reservation of usurious interest, unconscionability and fraudulent transfer.

Itria has sought dismissal of all claims against it, but some claims that the Debtors have asserted either are not disputed or are otherwise not ripe for resolution:

- The Debtors have asked the Court to declare that the parties' contracts are governed by New York law. Each of the contracts with the Defendants states that it is governed by New York law and no Defendant has contended otherwise, at least at this stage of the proceedings. The Debtors have not asked for rulings on the issue and the Defendants have identified no reason to dismiss this claim.

***3** • The Debtors have asked that I determine whether the claims of the Defendants are secured or unsecured and, if they are secured, what priority those claims have in relation to the claims of other secured creditors. Those determinations will depend at least in part on the nature and extent of other secured creditors' claims, the

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collateral that supports those other claims, the collateral that allegedly supports the Defendants' claims, the relative priorities of the creditors' competing interests in collateral, and the overall value of the relevant collateral. These are proper requests for relief, and they are not subject to resolution on a motion to dismiss.

- The Debtors have asked that I extend the automatic stay to cover individual guarantors and that I approve a rejection of the parties' contracts in the event they are found to be executory purchase contracts. The Debtors have not sought any present ruling as to those requests for relief, and no good reason has been offered as to why those asserted causes of action should be dismissed.

Debtors' counsel also has conceded, in written responses and during the hearing on December 10, 2025, that some of the asserted claims should be dismissed in whole or in part:

- Debtors' counsel acknowledged that if the entire underlying transactions with the Defendants were found to be fraudulent transfers and were avoided, the Defendants would then have a claim to recover the value of the consideration that they paid to the Debtors.

- Counsel acknowledged that the Debtors are limited liability companies and that under New York law they are not entitled to assert claims or defenses under New York's civil usury statute. *See* New York Limited Liability Company Law § 1104(a); *Am. E. Grp., LLC v. LiveWire Ergogenics, Inc.*, 2020 WL 469312, at * 7 (S.D.N.Y. Jan. 28, 2020).

- The Debtors acknowledged that under New York's criminal usury statute they would only have rights to challenge the Defendants' claims to recover the amounts that remain unpaid, and that the Debtors would not have affirmative rights (under the criminal usury statute standing alone) to recover amounts previously paid. *See Intima-eighteen, Inc. v. A.H. Schreiber Co.*, 172 A.D.2d 456, 457-8, 568 N.Y.S.2d 802 (1st Dep't. 1991).[1]

- Debtors' counsel stated that many of the claims asserted in the Amended Complaint (that the contracts were unconscionable, that they were contracts of adhesion, that they were the products of fraudulent inducement, and that performance is impossible) are not being pursued as independent grounds for relief and that the allegations made in support of those particular claims are relevant only as grounds for the equitable subordination claims that have been asserted.

The remaining claims before the Court that are properly subject to one or more of the motions to dismiss are: (1) claims that the entire agreements with the Defendants, and/or the prior transfers to the Defendants, and/or the Confession of Judgment issued in favor of Itria, and/or the later judgment entered in favor of Itria, should be voided on fraudulent transfer grounds; (2) contentions that the Defendants' claims should be disallowed under Section 502(d) of the Bankruptcy Code; (3) contentions that the transactions should be treated as loans (not sales of receivables) that violated the New York criminal usury statute, and issues as to the extent of the relief that the Debtors may obtain on this ground; (4) claims that some portions of the Defendants' claims should be disallowed because they represent claims to recover unmatured interest under Section 502(b)(2) of the Bankruptcy Code; and (5) contentions that Defendants' claims should be equitably subordinated. Itria has argued that the Debtors waived some or all of the asserted claims or are otherwise foreclosed from pursuing them; those defenses are discussed below in the context of the claims to which they relate.

Pleading Standards

***4** Rule 7012(b) of the Federal Rules of Bankruptcy Procedure, which incorporates Federal Rule of Civil Procedure 12(b)(6), permits a bankruptcy court to dismiss claims in an adversary proceeding if the complaint fails to state a claim upon which relief may be granted. In reviewing a motion to dismiss a court must accept the factual allegations of a complaint as true and must draw all reasonable inferences in the claimant's favor. *Ashcroft v. Iqbal*, 556 U.S. 662, 678, 129 S.Ct. 1937, 173 L.Ed.2d 868 (2009); *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 555–56, 127 S.Ct. 1955, 167 L.Ed.2d 929 (2007); *E.E.O.C. v. Staten Island Sav. Bank*, 207 F.3d 144, 148 (2d Cir. 2000). The factual allegations must consist of more than mere conclusory statements, however. *Twombly*, 550 U.S. at 555, 127 S.Ct. 1955. The allegations must be sufficient "to raise a right to relief above the speculative level" and provide more than a "formulaic recitation of the elements of a cause of action." *Id.* (citations omitted). "[O]nly a complaint that states a plausible claim for relief survives a motion to dismiss." *Iqbal*, 556 U.S. at 679, 129 S.Ct. 1937 (citing *Twombly*, 550 U.S. at 556, 127 S.Ct. 1955).

"A claim has facial plausibility when the plaintiff pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged." *Id.* at 678, 129 S.Ct. 1937 (citing *Twombly*, 550 U.S. at 556, 127 S.Ct. 1955). "The plausibility standard is not akin to a 'probability requirement,' but it asks for more than a sheer possibility that a defendant has acted unlawfully." *Id.* "[W]here the well-pleaded facts do not permit the court to infer more than the mere possibility of misconduct," a pleading is insufficient under Fed. R. Civ. P. 8(a) because it has merely "alleged" but not "show[n] ... that the pleader is entitled to relief." *Id.* at 679, 129 S.Ct. 1937; *see also id.* at 682, 129 S.Ct. 1937 (allegations in a complaint are insufficient if there is an "obvious alternative explanation" for the conduct alleged that is more "likely") (internal quotation marks and citation omitted).

If a pleading refers to agreements and other documents, it is proper for the court to consider the documents as part of the pleading in ruling on a motion to dismiss. *Grant v. Cnty. of Erie*, 542 Fed. Appx. 21, 23 (2d Cir. 2013) ("In its review [of a Rule 12(b)(6) motion to dismiss], the court is entitled to consider facts alleged in the complaint and documents attached to it or incorporated in it by reference, documents 'integral' to the complaint and relied upon in it, and facts of which judicial notice may properly be taken under Rule 201 of the Federal Rules of Evidence."); *see also Rothman v. Gregor*, 220 F.3d 81, 88–89 (2d. Cir. 2000) (noting that it is proper to consider documents that are quoted in or attached to the complaint or incorporated in it by reference, or that plaintiffs either possessed or knew about and upon which they relied in bringing suit); *I. Meyer Pincus & Assocs., P.C. v. Oppenheimer & Co.*, 936 F.2d 759, 762 (2d Cir. 1991) (noting that it is proper to consider a document upon which allegations are based, whether or not it is attached to the complaint). Where the allegations of a complaint are contradicted by the plain terms of the incorporated documents, the terms of the documents control. *Id.*; *see also Alexander v. Bd. of Educ. of City of New York*, 648 Fed. Appx. 118 (2d Cir. 2016) (summary order) (dismissing complaint where documents contradicted allegations).

Rule 7009 of the Federal Rules of Bankruptcy Procedure, which incorporates Rule 9(b) of the Federal Rules of Civil Procedure, imposes the additional requirement that allegations of fraud must be stated "with particularity." Fed. R. Bankr. P. 7009; *see also* Fed. R. Civ. P. 9(b). If a pleading alleges that fraudulent misrepresentations were made, for example, then the complaint must specify the statements that the plaintiff contends were fraudulent, identify the speaker, state where and when the statements were made, and explain why the statements were fraudulent. *Lerner v. Fleet Bank, N.A.*, 459 F.3d 273, 290 (2d Cir. 2006) (quoting *Mills v. Polar Molecular Corp.*, 12 F.3d 1170, 1175 (2d Cir. 1993)). Although "the fraud alleged must be stated with particularity," the requisite intent of the defendant "need not be alleged with great specificity." *See Chill v. Gen. Elec. Co.*, 101 F.3d 263, 267 (2d Cir. 1996) (citations omitted). "Malice, intent, knowledge, and other conditions of a person's mind may be alleged generally." Fed. R. Civ. P. 9(b), made applicable by Fed. R. Bankr. P. 7009. Nevertheless, to state a "plausible" claim of fraud a plaintiff "must allege facts that give rise to a strong inference of fraudulent intent." *Lerner*, 459 F.3d at 290 (quoting *Acito v. IMCERA Grp., Inc.*, 47 F.3d 47, 52 (2d Cir. 1995)).

The Transactions

***5** The Defendants' contracts with the Debtors are similar but not identical. Only Itria has sought dismissal of claims alleging that the transactions were disguised loans and not true sales of receivables. It is therefore proper to summarize the Itria agreement in some detail, though the agreements with the other Defendants can be described more generally.

A. The Itria "Receivables Sale Agreement."

Exhibit 3 to the Complaint is a "Receivables Sale Agreement" among Itria, GRG and Madison dated July 29, 2024. The agreement stated that Itria would purchase $640,000 of Receivables from the two Debtors (representing 9.1% of projected Receivables) at a price of $500,000. An attached "Offer Summary" estimated that the amounts owed to Itria would be paid within 308 days and that the amounts that Itria would earn were equivalent to an "estimated annual percentage rate" return of 65.25%.

The agreement did not identify any specific Receivables that were to be purchased. Instead, it purported to transfer, to Itria, a share of all future receipts with respect to Receivables until the $640,000 payment amount was reached. Section 2(c) of the agreement defined "Receivables" broadly to include all amounts received from customers for the purchase of products and/or services as well as all "accounts, future accounts, contract rights, choses in action and any other rights to payment" and all "insurance proceeds." ECF No. 3, Ex. 3, § 2(c). Section 2(c) purported to include "the Receivables

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of Merchant's subsidiaries and affiliated companies" and of entities that might be created in the future, though at this stage of the proceedings the parties have not been called upon to explain how (if at all) a sale of other companies' Receivables could have been accomplished in a contract to which only GRG and Madison were parties.

The parties agreed at page 1 of the agreement that the transaction represented a purchase of Receivables and not a loan, and the agreement stated that Itria was taking the risk that Receivables might not be available for remittance to it. The agreement also included waivers of any contention that the agreement was not a true sale of receivables. *Id*., §§ 1, 14(a).

The Itria agreement called for weekly payments to be made to Itria in the amount of $14,545.45, plus other direct payments to be remitted by certain credit card processors. Those payments to Itria were to be the exclusive methods of remittance unless and until a Material Breach occurred. GRG and Madison were parties to the Itria agreement, but their payment obligations were not stated separately. Instead, the payment obligations of the two companies appeared to be joint and several. The fixed payments were meant to represent an estimate of what 9.1% of the weekly Receivables collections would be, but the Debtors allege that this was not a good faith or reasonable estimate. Amended Complaint ¶¶ 36, 42(g).

Sections 1 and 5 of the Itria agreement gave GRG and Madison the right to seek a "reconciliation" as to prior payments that they had made and with respect to the ongoing weekly amounts that were to be paid. In the case of prior payments, the period covered by a reconciliation request could not exceed one calendar quarter. Itria had the right to request documentation, but it agreed that it would promptly calculate any excess in prior payments during the relevant period and that it would provide a "credit or refund" if such an excess were found. The agreement also stated that if there were a request for an adjustment of the weekly payment amount then documentation would be required on an ongoing basis. However, the agreement did not specify how any adjustment to the ongoing payments would be calculated.

***6** Notably, the agreement did not purport to grant separate reconciliation rights to the two separate Debtors. The reconciliation provisions appeared to operate on a collective basis, so that a significant reduction in one Debtor's receipts would not have warranted relief so long as the other Debtor's collections were sufficient to make up the difference. The agreement also stated that Itria had the right to decline a reconciliation request if a Material Breach was then in effect.

The agreement included representations, warranties and covenants by the Debtors, any breach of which was a "Material Breach." ECF No. 3, Ex. 3, § 7(A)(i). One such covenant, representation and warranty was that the Debtors had not entered into any merchant cash advance or loan agreement or other indebtedness that pledged or encumbered any of the Receivables, and that the Debtors would not do so during the term of the Itria contract. *Id.* §§ 2, 6(B)(vii). The Amended Complaint alleges, however, that at the time of the Itria transaction the Debtors were parties to prior secured loans that were backed by security interests in the Debtors' receivables, and that the Debtors also were parties to other merchant cash advance transactions that were still outstanding. At the hearing, Itria's counsel acknowledged that other parties' purported interests in the Debtors' receivables would have been disclosed in UCC filings and that Itria likely was aware of those other transactions. This raises the prospect that, with Itria's knowledge, the Debtors were in Material Breach of the Itria agreement from the moment it was executed.

Section 10 of the Itria agreement provided Itria with an ongoing right to obtain credit reports and other credit information about the Debtors. The Debtors also represented and covenanted in the Itria agreement that the bank statements and financial statements and other documents they had provided fairly represented their financial condition and results of operation (*id.* § 6(C)(i)), that all information provided about the Debtors' business was truthful, accurate and complete (*id.* § 6(C)(ii)), that the Debtors did not contemplate a bankruptcy filing (*id*. § 6(A)(vii)), that the Debtors would promptly notify Itria of any "material judgment" against the Debtors or their assets (*id*. § 6(A)(ix)), and that the Debtors would "immediately" notify Itria as to any material change in the condition of the Debtors or their business. *Id*. § 2. The Debtors agreed to conduct their business "in good faith and consistent with past practice" and not to take "any action designed to impair or frustrate Purchaser's ability to collect Receivables." *Id.* § 6(B)(i). The Debtors also agreed not to permit any event to occur that would cause a diversion of Receivables to any unauthorized account, *id*. § 6(B)(iii), that they had no intent to close their businesses, *id.* § 6(B)(vi), and that the would "continue to operate the Merchant business in good faith." *Id*., § 1.

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Other circumstances that constituted a "Material Breach" of the Itria agreement included any interference with Itria's rights to collect the amounts due to it, or the imposition of any material judgment or garnishment that was not disclosed to Itria. *Id.* § 7(A)(ii) and (iii). Any failure to pay the amounts due to Itria also was listed as a Material Breach. *Id*. § 6(B)(ii). However, the agreement states that if the "aggregate" amounts paid to Itria ultimately were less than the "Stated Amount Sold," despite the Debtors' best efforts to operate their businesses in compliance with the agreement, and so long as no other breach of the agreement had occurred, then such diminution in payments "shall not in itself be deemed a Material Breach." *Id.* § 7(B)(i). The Agreement also stated that a bankruptcy filing or the Debtors' insolvency "is not in itself" a Material Breach. *Id*., § 7(B)(ii).

***7** If a Material Breach occurs, then the agreement provides that Itria is entitled to recover the full amount owed to it, plus collection costs, including attorneys' fees and a fixed amount of $2,500 to cover "in-house" collection costs. Section 9 of the agreement included a grant of security interests to secure Itria's collection rights. Those security interests applied not only to Receivables, but also to all equipment and inventory and other assets of the Debtors. Itria also obtained a "Performance Guaranty" from the Debtors' individual owners that was triggered whenever any Material Breach occurred and that entitled Itria to seek full payment from the guarantors. The Debtors and the guarantors also executed confessions of judgment that could be filed in the event of any Material Breach.

The Debtors repaid $319,999.90 of the sums owed to Itria under the agreement, which is less than the amount of collections that Itria purported to purchase ($640,000) and also less than the amount that Itria actually paid to the Debtors ($500,000 minus a fee of $10,500, for a net payment of $489,500). At some point the Debtors stopped making payments to Itria, though it is unclear to the Court when that happened. Itria filed the confession of judgment in the Supreme Court, New York County on January 15, 2025, and judgment was entered against the Debtors and the individual guarantors on April 23, 2025. The judgment included an award of prejudgment interest from and after January 9, 2025 at the rate of sixteen percent (16%).

On October 3, 2025 (after the filing of the Amended Complaint) Itria filed a proof of claim (Claim No. 29-1) in the amount of $334,813.60, representing the judgment amount plus interest, costs, and continuing post-judgment interest. Itria contends that the claim is a secured claim and that all property of the Debtors located in the County of New York serves as collateral for its claim.

B. The Newco "Revenue Purchase Agreement."

GRG and Newco entered into a "Revenue Purchase Agreement" dated August 14, 2024. GRG agreed to sell, assign and transfer three percent (3%) of all Future Receipts, with "Future Receipts" being defined as "all of the Merchant's payments, receipts, settlements and funds paid to or received by or for the account of Merchant" in payment of "existing and future accounts, payment intangibles, credit, debit and/or stored value card transactions, contract rights and other entitlements arising from or relating to the payment of monies from Merchant's customers' and/or other payors or obligors ..." ECF No. 3, Ex. 4, p. 1. The maximum amount payable to Newco was to be $239,750, and Newco agreed to pay $175,000 minus an upfront fee of $7,050. The agreement did not identify any specific contract rights or receivables in which Newco was purchasing interests. Instead, the agreement contemplated that Newco would continue to be paid from all future receipts until such time as Newco recovered a set amount.

Section 1.10 and other provisions of the Newco agreement state that the amounts payable to Newco did not represent loan repayments and did not represent the payment of interest. Section 1.10 stated, however, that if a court determined otherwise, and if it determined that Newco had charged interest at a rate that was higher than legally permitted, then Newco "shall promptly refund to Merchant any interest received by [Newco] in excess of the maximum lawful rate."

GRG agreed to make fixed weekly payments of $7,493 to Newco. An attached "Offer Summary" estimated that it would take 32 weeks for the maximum amount to be paid to Newco. The difference between the amount paid by Newco and the amount to be paid to Newco was described in that same attachment as a "Finance Charge." The attachment also stated that the Finance Charge was equivalent to an estimated annual percentage rate return of 122.81%, though the agreement disclaimed that such amount should be treated as an interest rate.

***8** GRG repaid $152,861 to Newco, which was less than the maximum amount payable under the agreement ($239,750) and less than the amount actually paid by Newco ($175,000 minus the upfront fee of $7,050). On September 30, 2025 (after the filing of the Amended Complaint), Newco filed a

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proof of claim against GRG (Claim No. 19-1) in the amount of $120,403.20, which includes a claim for the amount that Newco did not recover ($86,889) plus other unspecified charges. Newco contends that its claim is secured by all assets of GRG.

C. The Square Advance "Standard Merchant Cash Advance Agreement."

Square Advance entered into a Standard Merchant Cash Advance Agreement dated September 26, 2024 with GRG and with non-debtor entities named Intermix, LLC and Binome, Inc. Square Advance agreed to pay $125,000 (minus an up-front fee of $5,000) for the purchase of $174,875.00 of Receivables, which were stated to represent an estimated 4% of future Receivables. "Receivables" was defined as all payments made by customers or other third-party payors in exchange for goods or services. No specific Receivables were identified as having been sold. Instead, the agreement treated Square Advance as having purchased a $174,875 share of all future Receivables. The obligations of the three parties identified as Merchants were not stated or computed separately. The Merchants agreed (apparently on a collective basis) to make weekly payments of $6,725.97 per week. An Addendum to the contract stated that "Early Payoffs" would be permitted such that the receipt of $143,750 by Square Advance would be treated as full payment if received on or before October 26, 2024, and the receipt of $150,000 would be considered full payment if received on or before November 25, 2024. The Debtors allege that the implied term of the Square Advance agreement was 26 weeks and that the implied interest rate was 132.673%.

GRG paid $99,509 to Square Advance pursuant to the agreement, which is less than the amount paid by Square Advance and less than the total amount that Square Advance was to recover under the contract. On October 3, 2025 (after the filing of the Amended Complaint) Square Advance filed a proof of claim (Claim No. 30-1) in the amount of $76,866.23. It contends that the claim is a secured claim.

D. The Smart Business "Sale of Future Receipts Agreement."

GRG and Smart Business entered into a Sale of Future Receipts Agreement dated December 6, 2024. It stated that Smart Business would purchase $350,000 of the monies that GRG received in the future from customers and other third-party payors, which was estimated to represent 3.86% of future receipts. Smart Business agreed to pay $250,000 minus an upfront fee of $12,500. GRG agreed to make weekly payments of $10,938 to Smart Business. The Debtors allege that the expected repayment period was 32 weeks and that the implied rate of return for Smart Business was 112.69%.

GRG paid $54,252 to Smart Business, which is less than the amount that Smart Business originally paid and less than the amount specified in the parties' agreement. On October 3, 2025, Smart Business filed a proof of claim (Claim No. 25-1), contending that GRG owes it $296,400.05, though the filing did not break down the components of the claim. Smart Business contends that its claim is a secured claim.

Discussion

I. Whether the Debtors Have Pleaded a Valid Fraudulent Transfer Claim.

Section 548 of the Bankruptcy Code permits a trustee to assert fraudulent transfer claims with respect to transfers that were made and/or obligations that were incurred within two years prior to a bankruptcy filing if the Debtors did not receive "reasonably equivalent value" in exchange and if the Debtors were insolvent (or met other financial tests) at the time the relevant obligations were incurred or the relevant transfers were made. 11 U.S.C. § 548. The transactions between the Debtors and each of the Defendants occurred in 2024, less than two years prior to the Debtors' bankruptcy filings. Section 1107 of the Bankruptcy Code provides that in a Chapter 11 case a debtor in possession has the powers that a trustee would otherwise have, and this includes the rights that a trustee would have to file claims under Section 548. *See* 11 U.S.C. § 1107(a).

***9** The Debtors have also invoked Section 544 of the Bankruptcy Code in support of their fraudulent transfer claims. *See* Amended Complaint ¶ 6. Section 544(a) permits a trustee (or a debtor in possession in a Chapter 11 case) to assert fraudulent transfer claims under state law that a debtor's creditors otherwise could have asserted. 11 U.S.C. § 544(a). New York's Debtor and Creditor Law permits a creditor to obtain the avoidance of an obligation or a transfer if a debtor did not receive reasonably equivalent value in return and if the debtor was insolvent at the time. *See* N.Y. Debtor & Creditor Law § 274(a).

The Amended Complaint appears at different times to challenge the validity of the entire obligations that the Debtors incurred, of the individual transfers that the Debtors made

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pursuant to those obligations, of the remaining claims of the Defendants, of the Confession of Judgment executed in favor of Itria and of the judgment that Itria obtained pursuant to that Confession of Judgment. *See* Amended Complaint ¶¶ 74, 76-78, 81-84, 74-78, 81-84, 87-90, 93-96, 99-102, 146, 213. I will address each of the possibilities to identify the claims that are properly asserted as fraudulent transfer claims.

A. Avoidance of the Underlying Obligations and Transactions in Their Entirety On the Theory That the Original Transactions Were Fraudulent Transfers.

The Amended Complaint alleges that the Debtors either received no value or less than reasonably equivalent value in their transactions with the Defendants and that the Debtors were insolvent at the times the obligations were incurred and/or when the transfers were made. If the Debtors prove these allegations then the entire transactions would be declared void, and the parties would be returned to the positions that they would have occupied if the transactions had never occurred. *See* 5 Collier on Bankruptcy ¶ 548.10 (16th ed. 2026) (avoidance amounts to the nullification of a transaction, which means that the transaction "is retroactively ineffective" and that the transferee legally acquired no rights or property, so that the trustee may act as though the transaction did not occur.)

Itria and the other Defendants argue that to date the Debtors have repaid less than the amounts that the Defendants paid to the Debtors, and therefore that no valid fraudulent transfer claim may be asserted. However, Section 548 of the Bankruptcy Code, and Section 274(a) of the New York Debtor and Creditor Law, allow a fraudulent transfer claim to be asserted not only with respect to actual cash transfers that have occurred to date, but also with respect to "any obligation" incurred by a debtor for less than a reasonably equivalent value. *See* 11 U.S.C. § 548; 5 Collier on Bankruptcy ¶ 548.03 (16th ed. 2026) ("unlike Section 547, Section 548 extends beyond simple transfers and enables avoidance of obligations as well"); N.Y. Debtor & Creditor Law § 274(a). Itria has argued that the Debtors have only challenged "transfers" and not the "obligations" that were incurred, but I do not believe that is a fair reading of the Amended Complaint. *See, e.g.,* Amended Complaint ¶ 213 ("[t]he obligations secured by the liens of the MCA Lenders and Negotiation Parties are subject to avoidance as a fraudulent conveyance and preserved for the benefit of the Estates.").

Itria and the other Defendants also argue that they provided "consideration" in the form of the payments that they made to the Debtors. For purposes of a fraudulent transfer claim, however, the issue is whether the amount of the consideration that was paid constituted "reasonably equivalent value" for the obligations that the Debtors incurred. The Debtors have alleged that there was an enormous disparity between the amounts the Defendants paid and the amounts that the Defendants were entitled to receive under their contracts. *Id.* ¶ 42. The Defendants argue that the amounts paid were reasonable despite these disparities, but the reasonableness of the payments and other questions as to whether "reasonably equivalent value" was paid are factual issues that are not appropriate for resolution on a motion to dismiss.

***10** Itria contended at oral argument that the Debtors' fraudulent transfer claims are entirely dependent on the success or failure of the Debtors' usury claims, but that plainly is not the case to the extent that the Debtors challenge the entirety of the underlying transactions on fraudulent transfer grounds. The Debtors may plausibly argue that the amounts paid by the Defendants did not constitute "reasonably equivalent value" regardless of whether the transactions were loans or sales, and regardless of whether any usury claim could separately be asserted.

The Debtors conceded at oral argument that if the entire transactions were avoided on fraudulent transfer grounds, then the Defendants would have unsecured claims to recover any amounts that they originally paid to the Debtors and that have not already been recovered through payments made by the Debtors. *See* 11 U.S.C. § 548(c).

B. May the Debtors Use Fraudulent Transfer Theories to Attack the Itria Confession of Judgment Standing Alone?

The Confession of Judgment was executed as part of the original Itria transaction. At times it appears that the Debtors seek to undo the Confession of Judgment standing by itself. If the Debtors seek to undo only part of the original Itria transaction on fraudulent transfer grounds, that result would not be permitted. Fraudulent transfer is a basis to avoid a transaction, not a basis to reform it. *In re People's Power & Gas, LLC*, 608 B.R. 333, 338-9 (Bankr. D. Conn. 2019). If a material part of the original deal was improper as a fraudulent transfer, the entire thing would come undone, not just a part of it.

C. May the Debtors Seek to Undo Individual Payments and/or the Itria Judgment on the Grounds that the

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Debtors' Failures to Assert Their Available Usury Defenses Were Themselves Fraudulent Transfers?

There is a separate issue as to whether the Debtors might have committed fraudulent transfers by their failures to assert usury defenses at the times when individual payment obligations came due and (in Itria's case) at the time Itria sought the entry of judgment against the Debtors.

New York law permits a limited liability company to assert criminal usury defenses as to obligations that remain unpaid. *See Adar Bays, LLC v. GeneSYS ID, Inc.*, 37 N.Y.3d 320, 333, 157 N.Y.S.3d 800, 179 N.E.3d 612 (2021) (hereafter cited as "*Adar Bays*"). The Debtors have acknowledged that as of today they would only have the right (on usury grounds standing alone) to challenge the obligations to the Defendants that are still outstanding. The Debtors contend, however, that at the times when prior payments came due the Debtors had the right to assert usury defenses and to avoid making those payments, but that the Debtors failed to do so. The Debtors also claim that, at the time that Itria filed the Confession of Judgment and sought the entry of judgment in its favor, the Debtors had the right to assert a usury defense, but they did not do so. The Debtors' counsel has argued that the Debtors were insolvent at all of these times, and that the Debtors' failures to assert usury defenses at these prior times were waivers of valuable rights that operated to the benefit of the Defendants and for which the Debtors received no further compensation. The Debtors therefore allege that the failures to assert defenses, the resulting waivers, and the individual transactions in which the waivers were effected, should be undone as fraudulent transfers. If valid, this theory would mean that all of the individual payments to the Defendants, and the Itria judgment, would potentially be undone. The parties would be restored to the positions they would have occupied if valid usury defenses had been asserted after the transactions initially closed but before the Debtors made any repayments.

***11** The Bankruptcy Code broadly defines the term "transfer" as including "each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with" property or an interest in property. 11 U.S.C. § 101(54). A release of claims qualifies as a "transfer" under this broad definition. *Carmel v. River Bank Am. (In re FBN Food Servs)*, 185 B.R. 265, 273 (N.D. Ill. 1995) ("[w]ithout doubt, causes of action and claims possessed by the debtor are property of the estate" and the release of such claims constituted a transfer); 5 *Collier on Bankruptcy* ¶ 543.03 ("transfers" include "transactions in which the debtor terminates or modifies intangible property rights, such as contract rights or releases of causes of action"). Failures to assert rights, or disclaimers of rights, may also constitute transfers. *United States v. Kapila*, 402 B.R. 56, 63 (S.D. Fla. 2008) (election with respect to net operating losses entailed the waiver of a present tax refund and constituted a "transfer").

The satisfaction of a valid debt is deemed to constitute reasonably equivalent value for fraudulent transfer purposes. If, however, the obligations to the Defendants were loans that were subject to valid criminal usury defenses at the times when the Debtors made prior payments, and if the Debtors instead made the payments without asserting those available defenses, then it is plausible for Plaintiffs to contend that the Debtors made transfers to the Defendants that did not satisfy valid outstanding debts and for which the Debtors did not receive reasonably equivalent value. The Debtors also failed to assert usury defenses when Itria sought the entry of judgment, and Itria itself argues that it received additional rights as the result of the Judgment entered in its favor, in that Itria acquired the right to full payment of the amounts that remained owing to it and foreclosed the Debtors (in the absence of a fraudulent transfer claim) from asserting any further usury defenses. If, as alleged, the Debtors were insolvent at the times of these transfers, then the transactions amounted to fraudulent transfers that may be undone.

This theory would require proof that the Debtors had valid usury defenses that could have been asserted at the relevant times. Itria argued during oral argument that allowing the Debtors to pursue such a claim would impermissibly permit an end-run around the limits that state law imposes on the assertion of usury defenses. I do not agree. State law provides that the Debtors' prior failures to assert usury defenses amounted to a termination of the Debtors' rights to challenge their prior payments and other transfers on usury grounds. There is a separate issue as to whether those losses or waivers of state law rights amounted to (or were part of) fraudulent transfers, and whether they therefore may be undone. Any transfer that is undone on fraudulent transfer grounds amounts to the invalidation of something that would otherwise be valid under state law. A litigation settlement is normally binding under state law, for example, but it may be undone if it amounted to the transfer of property without reasonably equivalent value at a time when the debtor was insolvent. The nullification of the Debtors' prior transfers on fraudulent transfer grounds, based in part on the fact that the Debtors had valid defenses that they failed to assert at the time, would not

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offend state law any more than any other successful fraudulent transfer claim would offend state law.

There may be issues that the parties have not yet fleshed out, but at this stage of the proceedings I will permit the Debtors to pursue fraudulent transfer claims on this basis.

D. Whether Avoidance of the Itria Judgment on Fraudulent Transfer Grounds Is Barred by *Res Judicata* or by the *Rooker-Feldman* Doctrine.

***12** Itria argues that the Debtors' fraudulent transfer claims are barred by *res judicata* and by the *Rooker-Feldman* doctrine. I disagree.

A fraudulent transfer claim under Section 548 exists only after a bankruptcy petition has been filed. The Debtors therefore did not own the Section 548 claims, and could not have asserted them, at the time of the Itria transaction or at time the state court judgment was entered in favor of Itria. The Section 548 claim therefore is not one that was actually litigated, or that could have been litigated, at the time the state court proceeding was filed or at the time the state court judgment was entered. The state court judgment cannot reasonably be treated as *res judicata* with respect to claims that did not yet even exist when the judgment was entered. *See Preston v. Nationstar Mortg. LLC (In re Preston)*, No. 24-21009 (JJT), 2025 Bankr. LEXIS 954, at *16-17 (Bankr. D. Conn. Apr. 16, 2025) (determining that a prior state court judgment did not bar a fraudulent transfer claim that was not and could not have been litigated in the prior state court action); *see also In re Fitzgerald*, 237 B.R. 252, 265 (Bankr. D. Conn. 1999) (holding that claim preclusion doctrines were inapplicable since, among other reasons, a fraudulent transfer claim was not and could not have been litigated in a prior foreclosure action).

In addition, a debtor in possession is not limited to the pre-petition debtor's own rights when a debtor in possession files a fraudulent transfer action. There are some causes of action (contract claims, for example) that a trustee or a debtor in possession inherits from a pre-petition debtor and as to which the trustee and debtor in possession are subject to all of the defenses (including claim preclusion) that would bind the pre-petition debtor. Fraudulent transfer and other avoidance actions are different. Those claims never belonged to the pre-petition debtor. They are claims that may be asserted only by a trustee, or by a debtor in possession who has the powers and responsibilities of a trustee in a Chapter 11 case. Claims under Section 548 are not derivative of the pre-petition debtor's own rights and they are not subject to defenses that could be asserted against the pre-petition debtor. *See Allegaert v. Perot*, 548 F.2d 432, 436 (2d Cir. 1977) (holding that avoidance action claims are "statutory causes of action belonging to the trustee, not to the bankrupt, and the trustee asserts them for the benefit of the bankrupt's creditors" and that a trustee was not subject to a debtor's prepetition agreement to arbitrate such claims); *Bethlehem Steel Corp. v. Moran Towing Corp. (In re Bethlehem Steel Corp.)*, 390 B.R. 784, 790 (Bankr. S.D.N.Y. 2008) (holding that fraudulent transfer claims are "statutory claims belonging to the trustee and are not claims derivative of the debtor's own rights"); *Buffalo Metro. Fed. Credit Union v. Mogavero (In re Cooley)*, No. 00-CV-0345E(M), 2001 WL 135822, at *3, 2001 U.S. Dist. LEXIS 1513, at *9 (W.D.N.Y. February 9, 2001) (holding that a trustee acts as a representative of the estate when exercising an avoiding power and "is not limited to the rights of the bankrupt").

***13** The whole purpose and effect of a fraudulent transfer claim is to nullify transfers and obligations to which the pre-petition debtor otherwise would be legally bound. It would be absurd, in considering a fraudulent transfer claim, to contend that a judgment is immune from attack just because the judgment bound the pre-petition debtor. *See, e.g., Dobin v. St. Andrew's Ests. 26, LLC (In re Hernandez)*, No. 22-14525-CMG, 2025 WL 2649077 at *8-9, 2025 Bankr. LEXIS 2318 at *24-26 (Bankr. D.N.J. Sept. 15, 2025) (holding that a trustee asserting an avoidance action claim acts for creditors and should be treated as a different party from the prepetition debtor for purposes of the application of *res judicata* and claim preclusion doctrines); *In re Cooley*, 2001 WL 135822, at *3, 2001 U.S. Dist. LEXIS 1513, at *9 (holding that prior statements by a debtor were not binding on a trustee who asserts an avoidance action claim because the trustee is not limited to the rights of the debtor in asserting such a claim). The Debtors in this case are debtors in possession who have the power and responsibility under Section 1107 to assert Section 548 claims on behalf of the estate, and in doing so they should not be subject to any restraints that would not apply to an independent trustee. *In re Bethlehem Steel Corp.*, 390 B.R. at 790.

The Debtors have also invoked Section 544 of the Bankruptcy Code in support of their fraudulent transfer claims. Amended Complaint ¶ 6. Claims asserted under Section 544 are claims that otherwise would belong to the Debtors' creditors. *In re Teligent, Inc.*, 307 B.R. 744, 749 (Bankr. S.D.N.Y. 2004). Those creditors were not parties to the state court action in which the judgment in favor of Itria was entered, and so the

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state court judgment cannot be considered *res judicata* with respect to the claims asserted under Section 544.

The fraudulent transfer claims also do not run afoul of the *Rooker*-*Feldman* doctrine. The *Rooker*-*Feldman* doctrine derives from the Supreme Court's decisions in *Rooker v. Fidelity Tr. Co.*, 263 U.S. 413, 415-16, 44 S.Ct. 149, 68 L.Ed. 362 (1923), and *District of Columbia Ct. of Appeals v. Feldman*, 460 U.S. 462, 486-87, 103 S.Ct. 1303, 75 L.Ed.2d 206 (1983), as clarified by the more recent decision in *Exxon Mobil Corp. v. Saudi Basic Indus. Corp.*, 544 U.S. 280, 293-94, 125 S.Ct. 1517, 161 L.Ed.2d 454 (2005). The gist of the *Rooker*-*Feldman* doctrine is that federal courts should not conduct the kind of review of a state court judgment that ought to be conducted by the state courts who have appellate jurisdiction. *Phila. Entm't & Dev. Partners, LP v. Dep't of Revenue (In re Phila. Entm't & Dev. Partners, LP)*, 879 F.3d 492, 498 (3d Cir. 2018). The fraudulent transfer claims that are asserted here do not fit that description. The fraudulent transfer claims did not belong to the Debtors at the time of the state court judgment, and they seek to undo transactions on grounds that do not require any review of the state court judgment itself. Under these circumstances the *Rooker*-*Feldman* doctrine is not applicable. *Id*. at 498-502 (holding that a fraudulent transfer claim does not involve a prohibited "appellate review" of a state court judgment or a relitigation, in federal court, of matters already litigated in the state court, and that the *Rooker*-*Feldman* doctrine does not bar the assertion of a fraudulent transfer claim); *In re Preston*, 2025 Bankr. LEXIS 954, at *10-11 (holding that the *Rooker*-*Feldman* doctrine does not apply to avoidance action claims and that the Bankruptcy Code authorizes a court to vitiate a state court judgment on fraudulent transfer or preference grounds); *Pryor v. Town of Smithtown (In re Jadeco Constr. Corp.)*, 606 B.R. 169, 184-5 (Bankr. E.D.N.Y. 2019) (collecting cases and holding that "[c]ourts examining the reach of the *Rooker*-*Feldman* doctrine have concluded that it has little to no application in the context of avoidance actions in the Bankruptcy Code"). Itria has not cited any authority to the contrary.

II. Claims Pursuant to Section 502(d).

Section 502(d) of the Bankruptcy Code states that any claim of a party "that is a transferee of a transfer" that is avoidable under sections 544 or 548 must be disallowed "unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable ..." 11 U.S.C. § 502(d). Defendants' motions to dismiss the Debtors' claims under Section 502(d) of the Bankruptcy Code depend on Defendants' arguments that all of the Debtors' fraudulent transfer claims should be dismissed. I have denied the motions to dismiss some of the fraudulent transfer claims for the reasons stated above, and so there is at this stage no basis to dismiss the claims under Section 502(d).

III. Whether The Debtors Have Pleaded Valid Usury Claims.

***14** Violations of the New York usury laws carry heavy consequences. Usurious transactions are void. N.Y. Gen. Obl. Law § 5-511. A lender who violates usury laws may be barred even from recovering the amount of its original loan and may be subject to other penalties as well. *See Adar Bays,* 37 N.Y.3d at 326, 157 N.Y.S.3d 800, 179 N.E.3d 612 (citing "the 300-year-old rule in New York that, where usury is established, the transaction is entirely void, preventing recovery of both principal and interest.") Corporations and limited liability companies are barred from asserting "civil" usury defenses under New York law, but they are not barred from asserting that transactions violate the 25% criminal usury limits in the Penal Law. *See* N.Y. General Obligations Law § 5-521(1); N.Y. Limited Liability Company Law § 1104(a) (permitting a limited liability company to assert a defense of criminal usury but otherwise barring such a company from interposing a usury defense). New York courts have held that these provisions allow corporations and limited liability companies to assert criminal usury as a defense to a claim to recover a debt, but that corporations and limited liability companies may not seek "affirmative" relief on usury grounds. *Intima-eighteen, Inc. v. A.H. Schreiber Co.*, 172 A.D.2d 456, 457-58, 568 N.Y.S.2d 802 (1st Dep't. 1991).

The Defendants have argued that the Amended Complaint impermissibly seeks affirmative relief on grounds of usury and that the Debtors' stand-alone usury claims should be dismissed. Itria argues more generally that its transaction was a sale of receivables as a matter of law and that the Debtors have waived arguments to the contrary or otherwise are barred from arguing the contrary. The other Defendants have not sought dismissal of the contentions that their transactions were loans, though they have made clear that they disagree with the Debtors' claims.

A. Whether The Debtors Seek Permitted Forms of Relief.

The Amended Complaint asks that the Itria transaction be voided on grounds of usury and that all of the Debtors' prior payments be returned. However, the Debtors acknowledge

that New York law would not permit them to seek such relief on usury grounds alone. The Debtors' challenges based on fraudulent transfer claims may proceed as described above (including the Debtors' contentions that they had valid usury defenses that were waived and that the waivers constituted fraudulent transfers), but the Debtors' contentions that prior payments should be undone, based on usury defenses standing alone, must be dismissed.

The Defendants also argue that the Amended Complaint seeks declaratory relief as to the Debtors' remaining obligations and that this also was a form of "affirmative" relief. There is support for that proposition. *Haymount Urgent Care PC v. GoFund Advance, LLC*, 609 F. Supp. 3d 237, 254 (S.D.N.Y. 2022)*; Streamlined Consultants, Inc. v. EBF Holdings LLC*, No. 21-CV-9528 (KMK), 2022 WL 4368114, at *3-4 (S.D.N.Y. Sept. 20, 2022). However, since the filing of the Amended Complaint the Defendants have filed proofs of claim. Defendants acknowledged at oral argument that the rule against "affirmative" relief does not bar the Debtors from challenging the proofs of claim on usury grounds. There is no reason why the Debtors' objections cannot be asserted in this adversary proceeding or why they cannot do so through the further amendments to the pleadings that will be required by this Decision. *In re Heritage Collegiate Apparel*, No. 24-47922 (TJT), —— B.R. ——, —— – ——, —— – ——, 2026 WL 159535, at *6-7, 7-8, 2026 Bankr. LEXIS 116, at *15, 18-19 (Bankr. E.D. Mich. Jan 20, 2026).

In the absence of a fraudulent transfer claim, the Judgment that Itria obtained would bar the Debtors from challenging their obligations to Itria on usury theories standing alone, as the judgment would be *res judicata* as to the usury defenses that the Debtors could have asserted. As explained above, however, the Debtors (as debtors in possession) have the same rights to assert fraudulent transfer claims as a trustee would have. That includes claims that the transfers that the Debtors previously made, and the Debtors' failures to assert usury defenses at the times those transfers were made, amounted to fraudulent transfers for the benefit of Itria. The Debtors, as debtors in possession, may assert those fraudulent transfer claims regardless of whether the pre-petition Debtors would have been able to do so. Similarly, the Debtors' prior payments and waivers may be undone on fraudulent transfer grounds even if they could not presently be undone based on usury theories standing alone.

B. Usury Generally.

***15** A transaction is not subject to usury laws unless the underlying transaction is properly characterized as a "loan" or as a "forbearance," and unless the benefits received by the non-debtor are properly characterized as "interest." *Seidel v. 18 East 17th Street, Inc.*, 79 N.Y.2d 735, 744, 586 N.Y.S.2d 240, 598 N.E.2d 7 (1992) ("[u]sury laws apply only to loans or forbearances"); *LG Funding, LLC v. United Senior Props. of Olathe, LLC,* 181 A.D.3d 664, 665, 122 N.Y.S.3d 309 (2d Dep't. 2020) ("[t[he rudimentary element of usury is the existence of a loan or forbearance of money, and where there is no loan, there can be no usury, however unconscionable the contract may be"). Not all transactions can be so easily characterized, however, and for so long as there have been strict usury laws the courts have had to struggle with the question of whether a party's gains on a particular transaction represent "interest" on a loan or instead represent profits on an at-risk investment. The courts' task is made immensely more complicated by the nearly boundless ingenuity of commercial parties and their counsel, who readily use every tool at their disposal to avoid the usury laws. *Quackenbos v. Sayer*, 62 N.Y. 344, 346 (1875) (observing, more than 150 years ago, that "[t]he shifts and devices of usurers to evade the statutes against usury, have taken every shape and form that the wit of man could devise ...")

Historically, the most common way in which parties have attempted to evade usury laws is by characterizing their transactions as sales rather than as loans. *See, e.g., Adar Bays,* 37 N.Y.3d at 342, 157 N.Y.S.3d 800, 179 N.E.3d 612 (2021) ("a common tool of lenders in the 1800s to avoid enforcement of usury law penalties – civil or criminal – was to disguise the loan as a 'sale of choses in action' exempted from the law"); *Quackenbos,* 62 N.Y. at 346 (recognizing that "the most usual form of usury was a pretended sale of goods"); *Schermerhorn v. Talman*, 14 N.Y. 93, 115-16 (1856) ("[t]he common expedient resorted to, therefore, to evade the statute is to give to the transaction the form of a sale, instead of a loan; a disguise which, whenever it can be discovered, is stripped off by the courts and the transaction declared usurious"). Often, of course, a sale is exactly what it purports to be. At other times, though, the form that a transaction takes may represent nothing more than an effort to disguise its true nature. *See Bishop v. Rider*, 143 Misc. 291, 295, 255 N.Y.S. 787 (2d Dep't 1932), *aff'd*, 261 N.Y. 512, 185 N.E. 717 (1933) (observing that "[w]herever you find usury, you will find a subterfuge of one kind or another. Circumvention is usually resorted to to give the color of legality.")

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New York courts have long been committed to the principle that "there is no contrivance whatever by which a man can cover usury" and that "no subterfuge shall be permitted to conceal it from the law." *Knickerbocker Life Ins. Co. v. Nelson*, 78 N.Y. 137, 149 (1879). For this reason, it is well-established in New York that in considering whether a transaction is usurious a court must consider the transaction in its totality and must judge it by its true character, rather than by the form it purports to take or by the names, labels or characterizations that the parties have elected to apply to it. *See Adar Bays,* 37 N.Y.3d at 334, 157 N.Y.S.3d 800, 179 N.E.3d 612 (2021) ("[w]hen determining whether a transaction is a loan, substance – not form – controls"); *Fleetwood Servs., LLC v. Richmond Cap. Grp. LLC,* No. 22-1885-CV, 2023 WL 3882697 at *2, 2023 U.S. App. LEXIS 14241 at *2 (2d Cir. June 8, 2023) (hereafter cited as "*Fleetwood (2d Cir.)*") ("[u]nder New York law ... 'substance' – not form – controls' when a court determines whether a transaction is a loan") (citations omitted); *LG Funding, LLC*, 181 A.D.3d at 665, 122 N.Y.S.3d 309; *Abir v. Malky, Inc.*, 59 A.D.3d 646, 649, 873 N.Y.S.2d 350 (2d Dep't. 2009); *Hall v. Eagle Ins. Co.*, 151 A.D. 815, 826, 136 N.Y.S. 774 (1st Dep't 1912), *aff'd*, 211 N.Y. 507, 105 N.E. 1085 (1914). Whether a particular transaction is merely a cover for usury is ordinarily a question of fact that is reserved for trial. *Adar Bays*, 37 N.Y.3d at 339, 157 N.Y.S.3d 800, 179 N.E.3d 612; *Beals v. Benjamin*, 33 N.Y. 61, 67 (1865); *Hicki v. Choice Capital Corp.*, 264 A.D. 2d 710, 711, 694 N.Y.S.2d 750 (2d Dep't. 1999).

New York courts have issued many decisions with respect to whether particular merchant cash advance transactions should be treated as loans or as sales of future receivables or receipts. Itria argues that the prevailing rule is that such transactions are sales and not loans, but the cases that Itria has cited for that proposition are not up to date. *See IBIS Capital Group, LLC v. Four Paws Orlando LLC*, 2017 WL 1065071, at *3 (Sup. Ct. Nassau Cty. Mar. 10, 2017); *Colonial Funding Network, Inc. v. Epazz, Inc.*, 252 F. Supp. 3d 274, 280 (S.D.N.Y. 2017); *Principis Cap., LLC v. I Do, Inc.*, 201 A.D.3d 752, 160 N.Y.S.3d 325, 327 (2022); *Womack v. Cap. Stack, LLC*, No. 18-cv-04192 (ALC), 2019 WL 4142740, at *7 & n. 9 (S.D.N.Y. Aug. 30, 2019). At one time, "[o]nly a small number of bankruptcy courts and commercial law scholars had begun challenging the prevailing characterization of these transactions as sales by looking beyond the contractual language to deeper commercial realities." K. Bruce, *Revenue-Based Finance in Bankruptcy and Beyond*, 45 Bankruptcy Law Letter (April 2025). However, "[t]he ground has shifted substantially in the years that have followed." *Id.*

***16** Many decisions over the past few years have held that particular merchant cash advance transactions were in reality loans and not sales.[2] Federal court decisions, particularly in this district, have tended to find that the transactions before them were loans as a matter of law, or that the relevant complaints asserted valid claims seeking such relief. New York state court decisions have produced more mixed results, but at least one New York State court has observed that the recent federal court decisions are "compelling" in the conclusions that they have reached. *See Hi Bar Capital LLC v. Parkway Dental Services, LLC*, 2022 WL 3757589, at *3 (Sup. Ct. Kings Cty. Aug. 25, 2022) (observing that "[r]ecently, Federal courts have engaged in a more thorough and exacting scrutiny of merchant cash advance agreements, looking at the agreements in a holistic and comprehensive manner, and the conclusions they have reached are compelling.")

Consideration of these prior decisions leads to a few important observations about the standards that should be applied in considering the usury contentions that the parties have made.

First, many New York courts that have considered merchant cash advance transactions have started from the proposition that in order to be a "loan" there must be an "absolute" right to repayment. This contention derives from a statement in *Rubenstein v. Small*, 273 App. Div. 102, 104, 75 N.Y.S.2d 483 (1st Dep't. 1947), that "[f]or a true loan it is essential to provide for repayment absolutely and at all events or that the principal in some way be secured as distinguished from being put in hazard." *Id.* Itria urges the Court to conclude that the Itria transaction cannot be a "loan" because Itria did not have full recourse against the Debtors in all conceivable circumstances and therefore did not have an "absolute" right of repayment, and also because Itria's recovery was subject to a theoretical contingency. I do not believe that Itria's contentions are correct statements of the holding in *Rubenstein* or of how the New York courts have applied the usury laws.

In the real world, limited recourse does not itself suggest that a transaction is something other than a loan. The quoted sentence from the *Rubenstein* decision recognized that a transaction may be a loan if there is an absolute right of repayment "or" if the principal is in some way "secured as

distinguished from being put in hazard." There are scores of non-recourse and limited recourse loans under which a lender's recovery is secured by a particular asset and in which the lender does not have full recourse against the buyer. The 1978 Bankruptcy Code even has a provision that addresses such loans. *See* 11 U.S.C. § 1111(b). In some such transactions the lender's principal is "put in hazard," to use the language of *Rubenstein*; a good example is a loan in which the lender's sole recourse is to the proceeds of a judgment on a litigation claim that has a highly uncertain outcome. But at other times a non-recourse loan may be fully secured and may involve no real risk other than the types of risks that any lender takes.

***17** Non-recourse loans in which the principal is "secured as distinguished from being put in hazard" are commonly regarded both legally and commercially as "loans," as well they should be. John F. Hilson and Steohen L. Sepinuck, *A "Sale of Future Receivables: Criminal Usury in Another Form*," 9 The Transactional Lawyer 1, 3 (Aug. 2019) (if absolute liability were the sole standard, then "[e]ven an over-secured, non-recourse loan would be exempt from the protections against usury," though "there is no good reason why that should be the case.") No lender's recovery is ever absolutely assured, after all. A lender in an ordinary unsecured loan transaction takes the risk of the borrower's insolvency. A lender who does not have recourse against a debtor, but who does have the right to recover from the borrower's property, may actually have a stronger assurance of recovery than an unsecured lender would have. Both types of transactions are normally regarded as "loans," even though the expected repayment sources may differ.

It also would be far too easy to evade usury laws if the only thing a lender needed to do to negate usury defenses would be to limit its recourse against a borrower in trivial ways, or to make its recovery contingent on highly remote or even nonexistent risks. If substance (not form) is to be determinative, as it is supposed to be, then a court must consider the scope and likelihood of the "risks" that a party has allegedly taken, and whether such risks are real or instead are just disguised efforts to evade the usury laws. *See Fleetwood (S.D.N.Y.)*, 2022 WL 1997207, at *10, 2022 U.S. Dist. LEXIS 100837, at *32. An agreement should not be considered a purchase of accounts receivable, as opposed to a loan, if there is not "a real risk on the part of the [buyer] that the [seller] may have reduced revenues or even no revenue." *Landmark Funding Grp. LLC v. Alt. Materials LLC*, No. 534708/2002, 2024 WL 866712, at *3, 2024 N.Y. Misc. LEXIS 852, at *7 (Sup. Ct. Feb. 29, 2024); *Lateral Recovery, LLC v. Cap. Merch. Servs., LLC*, 632 F. Supp. 3d 402, 452 (S.D.N.Y. 2022) (It is not sufficient that an "agreement is stated to have a reconciliation provision, an indefinite term and be non-recourse if those provisions are illusory"). A loan whose repayment is subject to a theoretical contingency may nevertheless be a "loan," and may be usurious, "where the contingency selected is so improbable as to convince the court or the jury that there was no real hazard and that the repayment of the loan was made subject to an improbable contingency merely to escape the statute against usury." 44B Am Jur2d Interest and Usury § 103. A theoretical "contingency" that is not real therefore does not suffice. *See, e.g., Echeverria v. Estate of Lindner*, No. 018666/2002, 2005 WL 1083704 at *7–8, 2005 N.Y. Misc. LEXIS 894 at *22-23 (Nassau Cty. Mar. 2, 2005) (holding that an advance of funds that was to be recovered only from a future judgment involved no real risk in light of the nature of the litigation claim at issue in that particular case, and that it was in reality a loan that violated usury laws); *In re Minor*, 443 B.R. 282, 287 (Bankr. W.D.N.Y. 2011) (holding that a pre-settlement assignment of future litigation proceeds was "suspect" on the ground, among others, that it appeared in reality to be a usurious loan); *see also* Hilson & Sepinuck, 9 The Transactional Lawyer at 4 ("A loan that is usurious except when pigs fly, is usurious.")

In order to be exempt from usury laws, the kind of risk that a funder takes must also be different from the risks that every lender takes, and for which lenders can only demand compensation at a rate of interest that the law permits. 72 N.Y. Jur. 2d Interest and Usury, § 86 (noting that a risk of loss that warrants an exception from usury laws "is to be distinguished from the risk of nonpayment that is inherent in every loan and that may only be compensated for by statutory interest"). The long-settled general rule has been summarized in one treatise as follows:

> ***18** An exception to the usury laws pertains where the principal is put at risk, and thus more than the legal rate of interest may be received, the excess in such case being allowed as a consideration for the risk of the principal in addition to the interest which is the consideration for the forbearance of the debt. To come within that exception to the usury laws, however, the risk of principal must be a substantial one. That is, it must have formed a real ingredient in the contract and the true consideration for the additional profit stipulated for, being clearly and beyond doubt not colorable or intended only as a cover for exacting more than the legal rate of interest for the mere use of the principal. There must be some greater hazard than that the

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borrower will fail to repay the loan or that the security will depreciate in value.

44B Am Jur2d Interest and Usury § 104. The risk that a borrower might die or become insolvent, for example, is a risk that every lender takes, but it is not the sort of risk or contingency that justifies an exemption from the usury laws. *See Colton v. Dunham*, 2 Paige Ch. 267, 273 (1830) ("the risk of loss by the death or insolvency of the borrower is not such a contingency or hazard as will take the case out of the operation of the [usury] statute"); *Vee Bee Service Co. v. Household Finance Corp.*, 51 N.Y.S.2d 590 (N.Y. Cty. 1944) (same).

Courts that adopt a mechanical focus on the existence of an "absolute" right to repayment (which is only part of the definition set forth in *Rubinstein*), and/or that focus mechanically on the existence of theoretical "contingencies" without assessing both the nature of those contingencies and whether those contingencies are substantial and realistic, are focused on form rather than substance, which is the opposite of what the New York Court of Appeals has commanded that courts do in applying the usury laws.

Second, New York courts have commonly considered three main factors in assessing whether a merchant cash advance transaction is, in reality, a loan as opposed to a sale: (1) whether there is a reconciliation provision in the agreement; (2) whether the agreement has a finite term; and (3) whether there is any recourse should the merchant declare bankruptcy. *Fleetwood (2d Cir.)*, 2023 WL 3882697, at *2, 2023 U.S. App. LEXIS 14241, at *2. I will discuss each of these factors below, but it is important to note that the three factors are neither exclusive nor decisive. The aim of the court's inquiry ultimately is to determine the true character of the underlying transaction, and many other factors may be relevant. *See Haymount*, 609 F. Supp. 3d at 247 ("while these three factors may be relevant to the analysis, they are far from dispositive"); *id.* at 249 (the 3 factors "are neither exclusive nor dispositive"); *Fleetwood (S.D.N.Y.)*, 2022 WL 1997207, at *9–10, 2022 U.S. Dist. LEXIS 100837, at *29-33 (holding that the three factors are a guide, but that the task is to evaluate the transaction as a whole by considering all relevant circumstances); *Lateral Recovery LLC v. Queen Funding, LLC*, No. 21-cv-9606 (LGS), 2022 WL 2829913, at *6, 2022 U.S. Dist. LEXIS 129032, at *18-19 (S.D.N.Y. July 20, 2022) (court explicitly considered other factors besides the three listed factors); *J.P.R. Mech. Inc.*, 2025 WL 1550541 at *7, 2025 Bankr. LEXIS 1319 at *19 (holding that the three factors merely provide a guide to the analysis and do not necessarily dictate the conclusion). Itria initially argued otherwise, but at oral argument Itria's counsel conceded that the cited factors are not exclusive and also are not decisive by themselves.

A court's consideration of the three factors, like a court's consideration of other aspects of the transactions, also should not be just a mechanical exercise, as though the three factors were just elements of form that should be toted on a scoresheet. If a transaction has a fixed term, full recourse against the debtor, and no reconciliation provisions, for example, then certainly those factors would suggest that the transaction is really a loan. But as already explained above, the fact that a purported "buyer" does not have recourse in all conceivable circumstances, or that a "buyer's" recovery is subject to a theoretical but not real risk, or that the buyer has taken a "risk" that in substance is just an ordinary credit risk, should not mean that a transaction is exempt from the usury laws. The inquiry "is not a quantitative exercise susceptible to replication by a computer program, but a comprehensive and heavily contextual endeavor." *CapCall, LLC v. Foster (In re Shoot the Moon, LLC)*, 635 B.R. 797, 813 (Bankr. D.Mont. 2021).

***19** Third, it ought to be clear (though sometimes it appears to be overlooked) that when a court is asked to determine whether, in substance, a transaction was actually a sale or a loan, the court should not begin and end its inquiry by considering only whether the transaction has all of the ordinary characteristics of a loan. In deciding what the substance of transaction really is, a court must also consider whether the transaction has the features one would expect to see in a sale. A court that does not do so has only examined half of the relevant question.

C. The Debtors Have Plausibly Alleged That the Itria Transaction Was A Loan.

Itria argues that its transaction was a valid purchase of an interest in future receipts and that Itria has taken a real risk that receipts might stop and that Itria might not be repaid. It also argues that the reconciliation provisions in its contract show that repayments can be adjusted to account for changes in receipts and that this shows that the transaction was not a loan. However, a number of features of the Itria transaction show that the Debtors have stated plausible claims that the transaction was in reality a loan.

First, although the agreement purports to be a purchase of a share of future receipts, there are two separate Debtors who are party to the Itria agreement. Itria did not purport to

buy separate shares of receipts from them. The two Debtors also do not appear to possess separate reconciliation rights. Instead, their obligations appear to be joint and several. If one Debtor suffered a calamity and ceased to have any future receipts, Itria would continue to collect the full amounts due to it from the other Debtor's receipts until such time as full payment was recovered. A breach of representations by one Debtor (as to its financial condition, for example) also would constitute a Material Breach and would give Itria full recourse to recover its full claim from both Debtors, even if the other Debtor itself had breached no provision of the contract. These features are sufficient to support the Debtors' allegations that the transaction is really a mutually-guaranteed loan rather than a true sale of receivables.

Second, it appears that the Debtors were in Material Breach of the Itria agreement from the moment it was executed. The Amended Complaint includes allegations about the Debtors' prior secured loans and the collateral in which those lenders had interests, and about prior merchant cash advance transactions in which the Debtors had engaged. The Itria agreement includes representations by the Debtors that no such other transactions and no such other security interests existed, and misrepresentations about those facts were Material Breaches. Itria had full recourse against the Debtors, and a secured claim, to recover all of the amounts that were payable to it whenever a Material Breach occurred, and so it appears (at least at this stage of the proceedings) that Itria had full recourse against the Debtors during the entire term of this transaction. Even Itria appears to concede, in its reply brief, that this is a fact that would support the conclusion that the transaction was a loan and not a sale. *See* Itria Reply Memorandum (ECF No. 45) at 11 (attempting to distinguish some prior authorities by contending that in those cases "merchants were in automatic default from the execution of the agreements, thereby allowing the funders to immediately enforce the personal guaranties"); *People by James v. Richmond Cap. Grp. LLC*, No. 45138/2020, 80 Misc. 3d 1213(A), at *4, 2023 WL 6053768 (Sup. Ct. N.Y. Cty. Sept. 15, 2023) (finding MCA agreements to be loans where the funders engineered merchants' immediate default by requiring merchants to make knowingly false representations that receivables were unencumbered the day the MCA agreements were executed).

***20** Third, a plausible case has been stated that Itria took no substantial market risks and that the risks of nonpayment that Itria took are merely credit risks in disguise. The "Receivables" out of which Itria was entitled to payment covered virtually every kind of receipt the Debtors would be expected to have, so that Itria was entitled to a full recovery "in virtually every imaginable circumstance." *Fleetwood (S.D.N.Y.)*, 2022 WL 1997207, at *11, *12, 2022 U.S. Dist. LEXIS 100837, at *34-35, 39. The only way that Itria was at any purported "risk" was if somehow the Debtors incurred an unexpected and calamitous loss of business that utterly terminated the Debtors' continued receipts of funds, so that the Debtors effectively ceased to be operating businesses, and if this somehow happened without the Debtors having violated any of the financial representations and business covenants set forth in the Itria agreement, without the Debtors having violated their covenants to provide immediate notice to Itria of changes in the Debtor's financial condition, and without the Debtors having previously breached any of the payment or other provisions in that agreement. Further discovery may reveal if this "risk" has ever materialized. When I asked Itria's counsel, at oral argument, to describe how it might come about, counsel could not do so.

The Debtors have also stated a plausible case that the "risk" posited by Itria – that the Debtors would cease to have any receipts at all – is just the risk that the Debtors' might entirely cease to exist as operating businesses and thereby suffer a corporate death. The risk that a borrower might die, however, is a risk that every lender takes, and the New York courts have made clear that this is not a risk that removes a transaction from the reach of the usury laws. *Colton v. Dunham*, 2 Paige Ch. 267, 273 (1830) ("the risk of loss by the death or insolvency of the borrower is not such a contingency or hazard as will take the case out of the operation of the [usury] statute"); *Vee Bee Serv. Co.*, 51 N.Y.S.2d at 600 (same); 72 N.Y. Jur. 2d Interest and Usury, § 86 (noting that a risk of loss that warrants an exception from usury laws "is to be distinguished from the risk of nonpayment that is inherent in every loan and that may only be compensated for by statutory interest"). As Professors Hilson and Sepinuck have observed:

> 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.

9 The Transactional Lawyer at 3.

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Other provisions in the agreement support the contention that Itria was really taking on credit risk, not market risks. The Itria agreement includes representations that the Debtors were solvent, that their financial statements and disclosures were accurate, that no material adverse event had occurred or was expected, that no material judgment had been entered, and that the Debtors were not contemplating bankruptcy. Breaches of these credit-related covenants constituted "Material Breaches" that gave Itria full recourse against the Debtors and the guarantors, even if no diminution in receipts occurred.

Fourth, the Itria transaction does not have the features one would expect to find in a true sale transaction. *Fleetwood (S.D.N.Y.)*, 2022 WL 1997207, at *11, 2022 U.S. Dist. LEXIS 100837, at *34-35 (holding that the agreement in that case had none of the characteristics of a sale of receivables in terms of the transfer of risk and rewards); *J.P.R. Mech. Inc.*, 2025 WL 1550541, at *8, 2025 Bankr. LEXIS 1319, at *26 (finding a loan where a transaction lacked the provisions that a true sale would have); *Hilson & Sepinuck*, 9 The Transactional Lawyer at 3 ("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"). Among other things:

***21** • The agreement does not identify any particular receivables that are being purchased. *Haymount*, 609 F. Supp. 3d at 249 (citing the fact that no specific receivables or accounts were identified as a factor that showed that the purported risks of a buyer did not really exist); *Funding Metrics, LLC v. NRO Boston, LLC*, No. 64202/2016, 2019 WL 4376780, at *4, 2019 N.Y. Misc. 4878, at *10 (Sup. Ct. Westchester Cty. Aug. 28, 2019) (finding a loan where, among other things, an MCA agreement purported to buy receivables but did not designate any actual receivables that were dedicated to repayment); *J.P.R. Mech. Inc.*, 2025 WL 1550541, at *8, 2025 Bankr. LEXIS, at *26. Itria therefore did not assume the credit risks of any particular customer, or the risks of nonpayment associated with any particular receivable. *Fleetwood (S.D.N.Y.)*, 2022 WL 1997207 at *11, 2022 U.S. Dist. LEXIS 100837 at *34-35; *Haymount,* 609 F. Supp. 3d at 247 ("If the lender's risk is derivative or secondary and the borrower remains liable and bears the risk of non-payment by the account debtor, while lender only bears the risk that non-payment will leave the debtor unable to pay, there isn't a bona fide purchase of receivables.")

• Itria requested information, representations and covenants about the Debtors' financial condition, but allegedly requested no information and did no investigation as to the financial condition or creditworthiness of any of the parties who would be making payments with respect to Receivables. Amended Complaint ¶ 42, 123-126.

• The Itria agreement also contemplated fixed weekly payments; those payments could potentially be adjusted if the Debtors so requested, but there appears to be no mechanism by which Itria would receive the benefit if collections were received faster than anticipated. Itria therefore did not acquire the upside a that buyer ordinarily would expect. *Fleetwood (S.D.N.Y.)*, 2022 WL 1997207 at *10–11, 2022 U.S. Dist. LEXIS at *34-35.

• If a customer failed to pay, the "buyer" in a true sale transaction would be expected to have the right to collect from the customer. *Id*. at *11, 2022 U.S. Dist. LEXIS at *35; *J.P.R. Mech. Inc.*, 2025 WL 1550541, at *8, 2025 Bankr. LEXIS, at *26. That was not the case here. Itria had no rights against customers unless some other Material Breach occurred.

Fifth, the Debtors have plausibly alleged that the reconciliation provisions in the Itria agreement were illusory and that Itria did not actually have staff to perform reconciliations. Amended Complaint ¶¶ 41-42. That allegation is sufficient to support a claim that the transaction is really a disguised loan. *See, e.g., Davis v. Richmond Capital Grp., LLC*, 194 A.D.3d 516, 517, 150 N.Y.S.3d 2 (1st Dep't. 2021); *see also Haymount*, 609 F. Supp. 3d at 248-9; *Lateral Recovery LLC*, 2022 WL 2829913, at *5, 2022 U.S. Dist. LEXIS 129032, at *15 (finding a loan where, among other things, the lender's obligation to reconcile was dependent on documentation to lender's satisfaction and lender could therefore nullify the obligation). Itria can and does dispute the Debtors' allegation, but that is just a factual issue for trial, not an issue to be resolved on a motion to dismiss.

Sixth, the Debtors have plausibly alleged that the agreement provides Itria with many ways to collect on its debt even if the debtor stops generating receivables. *Haymount*, 609 F. Supp. 3d at 249; *LG Funding, LLC,* 181 A.D.3d at 666. The Itria agreement includes representations that the Debtors were solvent, that they had made accurate disclosures of their normal revenue streams, that no material adverse event had occurred or was expected, that no material judgment

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had been entered against them, and that the Debtors were not contemplating bankruptcy, as well as covenants that the Debtors would continue to operate their businesses and would continue in good faith to generate receivables. Any breach of those representations and covenants was a Material Breach that gave Itria full recourse against the Debtors and the guarantors. Bankruptcy itself is not a listed default, but almost any bankruptcy would "interfere" with Itria's collection rights or require changes to the accounts that the Debtors use, and these would separately constitute defaults under the Itria contact. *See J.P.R. Mech. Inc.*, 2025 WL 1550541, at *8, 2025 Bankr. LEXIS 1319, at *23-24 (noting that almost any bankruptcy would necessarily interfere with the defendant's right to collect and therefore would cause a default giving full recourse against the debtor). There are also many other circumstances that constitute Material Breaches under the Itria agreement and that entitle Itria to full recourse against the Debtors (including in bankruptcy), regardless of whether the Debtors are continuing to have receipts. *Akf Inc. v. Haven Transp. Bus. Sols. Inc.*, No. 22-cv-269 (MAD/CFH), 2024 WL 2941746, at *7, 2024 U.S. Dist. LEXIS 103271, at *18-19 (N.D.N.Y. June 11, 2024) ("Despite the[ ] assertions in the Agreement of being left without recourse in the event of a bankruptcy, it seems virtually certain that FundKite would be able to file a claim in any bankruptcy proceeding, as a secured creditor, for any remainder of the [amount] owed.")

***22** Similarly, the guarantors' obligations are not limited to situations in which the Debtors have actually received funds and have failed to pay them to Itria, or have otherwise interfered with Itria's collections. They instead apply whenever any Material Breach occurs, including an alleged misrepresentation about the Debtors' financial condition or a failure to provide Itria with immediate updates as to the same. *See Fleetwood (2d Cir.)*, 2023 WL 3882697, at *2, 2023 U.S. App. LEXIS 14241, at *4 (guarantees are suggestive of a loan when they are not limited by the purportedly contingent nature of the merchant's obligation). The many provisions in the agreement regarding representations about the Debtors' finances, the nature of the events that constituted Material Breaches, the acceleration provisions, the personal guarantees, and the secured claims granted in favor of Itria are terms more commonly found in lending agreements than in true sales of receivables. K. Bruce, Revenue-Based Finance in Bankruptcy and Beyond, 45 Bankruptcy Law Letter 1, 3 (April 2025).

Seventh, there are features of the reconciliation provisions in the Itria agreement that undercut Itria's contentions about the "robust" protections that these provisions allegedly provide. In Itria's view, the reconciliation provisions provide assurances that actual payments will not exceed the proper percentage of the Debtors' actual recoveries. However, Section 5 of the Itria agreement also limits a reconciliation request based on past receipts to a period that does not exceed a calendar quarter. No explanation has been provided as to the reason for this time limit. The agreement also gives Itria the right (if a reconciliation request is properly documented) to give the Debtors a "credit" instead of a refund. A credit just reduces future payments and does nothing to address any potential excess in payments that might have already occurred. Each of these features is designed to assure that Itria can keep some or all of the payments that have already been made to it, even if the records show that the payments were excessive, which plausibly supports the contention that the transaction was not really a "sale" of an interest in receivables.

The provisions of Itria agreement regarding a "forward adjustment" in payments also do not include any specifics as to how such a forward adjustment might be calculated. Assume, for example, that a debtor had a sudden and drastic reduction in receipts. If a forward adjustment were to be based on the debtor's average collections over a past period (a calendar quarter, for example), then there would be an automatic time delay before the reduction in periodic payments would match the actual current reduction in collections. Further evidence will be required as to how this feature of Itria's reconciliations actually worked and whether, realistically, it was designed in a manner that is consistent with the manner in which a "sale" ordinarily would work.

Eighth, Itria's arguments that its agreement does not have a "fixed duration" does not carry the weight that Itria contends. The agreement provides for fixed monthly payments, so that the expected duration of the agreement can easily be calculated. *Lateral Recovery LLC*, 2022 WL 2829913, at *6, 2022 U.S. Dist. LEXIS 129032, at *16; *J.P.R. Mech. Inc.*, 2025 WL 1550541, at *8, 2025 Bankr. LEXIS 1319, at *22 (same). The expected repayment term might change in the event of a reconciliation, and that is certainly a factor to be considered. However, I cannot accept Itria's contention that such a potential change in the repayment period somehow means that the transaction was not a loan as a matter of law.

The existence of a fixed repayment term is a factor that suggests that a "sale" is really a loan, but that does not mean that the opposite is always true. There are many loans that do not have fixed terms, the most common of which

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is a "demand" loan that is repayable only when demand is made and not on a fixed schedule. There are also loan transactions that include provisions under which reductions in the borrower's income may result in a suspension of payments and a postponement of maturity dates – the most common ones that come to mind are student loans, which may have such features included in the loan terms themselves. Student loans may also include provisions under which payments (including interest accruals) are deferred if the borrower goes back to school, or enters a graduate fellowship program, or is employed in public service, or is in military service. These are, essentially, advance agreements to forbear from the collection of a debt under certain circumstances. So far as I am aware, nobody believes (or reasonably could argue) that these advance forbearance provisions mean that the student loans are no longer loans. The New York usury laws apply not only to agreements to lend money but also to "forbearance" agreements, so it would be highly peculiar if the presence of a provision in an agreement that calls in advance for forbearance under certain conditions would itself be deemed to be a factor that negates the application of the usury laws.

***23**
* * *

The foregoing points should not be interpreted as rulings on the merits of the parties' respective claims. They are only intended to identify grounds on which the Debtors have stated valid claims at the pleading stage. A true assessment of the character of the parties' transactions will await a trial on the merits.

D. Itria's Waiver Argument.

Itria argues that the Debtors have waived any contention that the transactions were loans and not sales. New York courts have been curiously inconsistent in how they have treated such waivers.

Some New York courts appear to have treated such contractual waivers as enforceable, citing general case law regarding parties' rights to waive counterclaims or affirmative defenses and treating waivers of usury defenses as matters that are no different from waivers of such other defenses. *See, e.g., Avanza Cap. Holdings, LLC v. Arm Consulting Corp.*, No. 511195/2025, 2025 WL 3554710 at *1, 2025 N.Y. Misc. LEXIS 10121 at *2 (Kings Cty. Dec. 10, 2025) (holding that a waiver in a merchant cash advance agreement is enforceable and relying on general case law regarding the contractual waiver of offsets, defenses and counterclaims); *Feldman v. Torres*, 34 Misc.3d 47, 939 N.Y.S.2d 221, 224 (N.Y. App. Term 2011) (providing that contracting parties may waive defenses, including usury); *RMP Capital, Corp. v. Victory Jet LLC*, No. 12-6197, 2013 WL 1822727, at *5 (N.Y. Sup. Ct. Suffolk Cty. Apr. 12, 2013) (trial order) (enforcing a contractual waiver of a usury defense and other defenses). Itria urges me to adopt that same approach here, citing a number of cases that deal generally with the waiver of potential defenses, particularly when such waivers have been made by guarantors.

Other New York courts, however, have adopted a different rule where an arguably usurious contract includes a waiver of usury defenses. Many courts have held that a usurious agreement is void and that any waivers contained therein (including waivers of usury defenses) are also void, while others have held more generally that the enforcement of a waiver of a criminal usury defense is against public policy. *See Hammelburger v. Foursome Inn Corp.,* 76 A.D.2d 646, 650, 437 N.Y.S.2d 356 (2d Dep't. 1980) ("it would seem to follow that a party cannot waive his right to be protected from criminally usurious loans"); *Singh v. LCF Group, Inc.*, No. 601297-23, 2023 WL 5760139 at *6, 2023 N.Y. Misc. LEXIS 5285 at *17-18 (Nassau Cty. July 25, 2023) (Usurious contracts are void and "Plaintiffs' ability to raise usury in defense to confessed judgments is well-established and cannot be waived"); *Reserve Funding Grp. LLC v. Cal. Organic Fertilizers, Inc.,* No. 24-CV-1112 (ARR), 2024 WL 1604195, at *2, 2024 U.S. Dist. LEXIS 67438, at *5 (E.D.N.Y. Apr. 12, 2024) (holding that usury is an affirmative defense but further noting that usurious agreements may not be enforced and that "[c]riminal usury cannot be waived by contract"); *Hi Bar Cap., LLC v. Excell Auto Grp., Inc. Karma of Palm Beach, Inc.,* No. 502846/2022, 2023 N.Y. Misc. LEXIS 68877 at *5-6 (Kings Cty. Jan. 12, 2023) (holding that "the defense of criminal usury cannot be waived as such would violate public policy"); *Haymount*, 635 F. Supp.3d at 242 (finding class action waivers to be void if the underlying contract was void on usury grounds); *Nicole Bolt Comer v. Advanced Capital, Inc.,* No. 719947/19, 2020 N.Y. Misc. LEXIS 9101, at *5 (Queens Cty. May 27, 2020) (waiver of usury contentions in a loan agreement is contrary to public policy); *Lateral Recovery LLC v. Funderz.net, LLC*, No. 22-cv-2170 (LJL), 2024 WL 4350369, at *4 n.8, 2024 U.S. Dist. LEXIS 176985, at *10 n. 8 (S.D.N.Y. Sept. 27, 2024) (refusing to enforce a "savings clause provision" that included a waiver of usury defenses). This result is consistent with the principle that where the agreement is itself rendered illegal and void (on usury or other grounds), courts will not sever and

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enforce incidental legal clauses, including purported waivers. *Moss v. First Premier Bank*, No. 2:13-cv-05438 (ERK), 2020 WL 5231320, at *4–5, 2020 U.S. Dist. LEXIS 160253, at *9-10 (E.D.N.Y. Sept. 2, 2020) (holding that a class action waiver in a usurious contract was not enforceable); *Manufacturers Hanover Trust Company/Capital Region v. Meadowdale Dev. Co.*, 91 A.D.2d 1087, 1088, 458 N.Y.S.2d 700 (3d Dep't. 1983) (refusing to enforce a waiver of usury defenses in a loan modification and extension agreement).

***24** New York cases have held that a borrower may be estopped from asserting usury defenses if the borrower induces an innocent third party to acquire the lender's position based on the borrower's assurances that usury defenses do not exist. *See Hammelburger v. Foursome Inn Corp.*, 54 N.Y.2d 580, 592, 446 N.Y.S.2d 917, 431 N.E.2d 278 (1981). However, there is no allegation that anything of that kind has happened in this case. New York cases have also held that parties may waive usury defenses in subsequent settlement agreements, but even in that circumstance the New York courts have invalidated such waivers if "the original usurious obligation transcends into the parties' subsequent agreement." *Adar Bays, LC v. 5Barz Int'l, Inc.*, 2018 WL 3962831, at *7, 2018 U.S. Dist. LEXIS 139843, at *16 (S.D.N.Y. Aug. 16, 2018); *Aquila v. Rubio*, No. 33561-12, 2016 WL 1761968 at *7, 2016 N.Y. Misc. LEXIS 1581 at * 21 (Suffolk Cty. May 2, 2016).

I note that some New York court decisions have cited to the waiver provisions in merchant cash advance agreements while then going on to consider whether the transactions were truly "loans" or "sales," thereby treating the waiver language as irrelevant or unenforceable, though without discussing the issue further. *See, e.g., Barrier Grp. Inc. v. BMF Advance LLC*, No. EF004150-2022, 2023 WL 9183857 at *8, 2023 N.Y. Misc. LEXIS 1032 at *19 (Orange Cty. Mar. 15, 2023). We have attempted to determine how courts have treated waiver issues in the more New York recent cases involving merchant cash advance transactions, and it appears that the defendants have not even asserted waiver arguments in most of those cases, though waiver provisions are normally (if not always) included in the underlying contracts. Itria has urged me to dismiss the Debtors' usury claims on waiver grounds, but the other Defendants have not done so, even though their contracts include similar waiver provisions.

Usurious agreements are void in their entirety, so it would be very odd to say that a usury violation could be cleansed just by adding waiver language to the originally usurious agreement itself. The prevailing rule in New York, as described above, is that such waivers are not enforceable. This also appears to be the prevailing rule in other jurisdictions. *See* 44B Am Jur2d Interest and Usury § 183 ("The decisions seem universally in accord that a borrower cannot, during the existence of the debt, and while the relation of debtor and creditor continues, by executory agreement of any kind or nature, relinquish claims or defenses based upon an exaction of usury, but they also agree that in executed agreements of settlement, concluding the relations of the parties, based upon valid and adequate consideration, honest differences, and good faith, such claims and defenses, involved in past transactions, may be released.")

The purported waivers in the transaction documents therefore would not have barred the Debtors, at an earlier time, from asserting usury defenses to their payment obligations or to Itria's request for entry of a judgment. As a matter of New York state law, the Debtors' failure to raise the affirmative defense of usury in the New York State court filed by Itria would be binding on the Debtors and would constitute a waiver of the usury defense as a matter of New York state law. *Prof'l. Merch. Advance Capital, LLC v. C Care Servs., LLC*, 2015 WL 4392081, at *2, 2015 U.S. Dist. LEXIS 92035, at *5 (S.D.N.Y. July 15, 2015); *Higgins v. Erickson (In re Higgins)*, 270 B.R. 147, 156 (Bankr. S.D.N.Y. 2001). As noted above, however, the Debtors have stated plausible claims that the Debtors' failures to raise defenses at an earlier time amounted to fraudulent transfers, so that the prior waivers should be undone and the transactions of which they were a part should be nullified, and the Debtors (as debtors in possession) are entitled to pursue those fraudulent transfer claims.

F. Itria's Argument About Its Alleged Intent.

***25** Itria contends that the Amended Complaint does not fairly allege that Itria "knowingly" charged usurious interest, but in fact the Amended Complaint explicitly alleges that Itria and the other Defendants purposely disguised their loan transactions for the purpose of evading usury laws. *See* Amended Complaint ¶ 24. To the extent that any allegation of intent is required, it is included in the Amended Complaint.

IV. The Debtors' Contentions that the Defendants Seek "Unmatured Interest."

Section 502(b)(2) of the Bankruptcy Code provides that claims to recover unmatured interest should be disallowed. 11 U.S.C. § 502(b)(2). There is an exception for secured claims, but only to the extent that the value of the claimant's security

interest is sufficient to cover a post-petition interest accrual. 11 U.S.C. § 506. The Debtors allege that other creditors have senior interests in the Debtors' assets and that the Defendants' claims should be treated as unsecured claims. However, the Amended Complaint does not sufficiently allege that any "unmatured" interest is owed. Instead, it describes the expected payment terms for each agreement and makes clear that all of the payments due to the Defendants would have come due prior to the date of the bankruptcy filings. In that case, the amounts that the Debtors wish to characterize as "interest" payments would already have accrued. The interest might be unpaid, but it would not be "unmatured." I will dismiss this claim in the Amended Complaint, without prejudice to repleading if the Debtors believe that a repleading is possible.

V. The Equitable Subordination Claims.

The Debtors have asserted a host of wide-ranging allegations about unconscionability, fraudulent inducement, impossibility and other theories, only to allege at oral argument that they are relevant only to the claims of equitable subordination. Frankly, it is too difficult at this stage to parse just what specific allegations are the bases for the equitable subordination arguments and which ones suffice or do not suffice. I will dismiss the equitable subordination claims due to the lack of clear pleading, without prejudice to the Debtors' rights to restate their theories of equitable subordination in an amended pleading and without prejudice to the Defendants' rights to challenge the sufficiency of the same.

Conclusion

For the foregoing reasons, the Defendants' motions to dismiss the claims in the Amended Complaint are to be granted in part and denied in part. More particularly:

- The motions to dismiss are DENIED with respect to Plaintiffs' contentions that the entire transactions with the Defendants were fraudulent transfers;
- The motions to dismiss are DENIED with respect to Plaintiffs' contentions that their failures to assert usury defenses at the time individual payments came due were waivers of valuable rights that inured to the benefit of the Defendants and that enabled the Defendants to receive payments to which they would not have been entitled if the defenses had been asserted, and that the waivers and payments should be avoided on fraudulent transfer grounds;
- Itria's motion to dismiss is DENIED with respect to Plaintiffs' contention that their failure to assert usury defenses at the time Itria sought the entry of judgment were waivers of valuable rights that inured to the benefit of Itria and that should be avoided on fraudulent transfer grounds;
- The motions to dismiss are DENIED as to Plaintiffs' claims under Section 502(d) of the Bankruptcy Code;

***26** • The motions to dismiss are GRANTED to the extent that Plaintiffs have asserted rights and defenses under New York's civil usury laws;

- The motions to dismiss are GRANTED to the extent that Plaintiffs have sought to recover prior payments based on criminal usury theories standing alone (though as stated above Plaintiffs may argue that their prior failures to assert usury defenses should be undone on fraudulent transfer grounds and may seek to recover prior payments pursuant to those fraudulent transfer claims);
- The motions to dismiss are DENIED as to Plaintiffs' claims that the remaining obligations owed to the Defendants are barred by New York's criminal usury laws;
- The motions to dismiss are GRANTED as to Plaintiffs' claims of unconscionability, fraudulent inducement, impossibility and as contracts of adhesion;
- The motions to dismiss are GRANTED as to Plaintiffs' contentions that the Defendants seek the payment of "unmatured interest," without prejudice to Plaintiffs' right to replead that claim; and
- The motions to dismiss are GRANTED as to Plaintiffs' claims of equitable subordination, without prejudice to Plaintiffs' rights to clarify and to replead their allegations.

A further amended complaint should be filed to conform to these rulings. The amended pleading should clearly separate the remaining causes of action and separately plead the elements of each such claim and should also eliminate the duplication in the asserted claims, so that the parties and the Court will have a clear roadmap as to the issues that must be addressed and the relief that is being sought under each theory.

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The parties are directed to confer and to prepare an order that gives effect to these rulings and that establishes a deadline for the filing of a further amended complaint.

All Citations

--- B.R. ----, 2026 WL 482170

Footnotes

1 This concession was limited to the relief that the Debtors could seek based on usury arguments standing alone. The Debtors have separately argued that they had the right to assert usury defenses when prior payment obligations came due, and that the failures to assert those defenses were waivers of valuable rights that inured to the benefit of the Defendants and that should be avoided on fraudulent transfer grounds. Those separate fraudulent transfer contentions are discussed in Part I(C) of this Decision.

2 *See, e.g.*, *Fleetwood Servs., LLC v. RAM Capital Funding, LLC,* No. 20-CV-5120 (LJL), 2022 WL 1997207, 2022 U.S. Dist. LEXIS 100837 (S.D.N.Y. June 6, 2022) (hereafter cited as "*Fleetwood (S.D.N.Y.)*"), *aff'd sub nom. Fleetwood Servs., LLC v. Richmond Cap. Grp. LLC*, No. 22-1885-CV, 2022 WL 1997207, 2022 U.S. Dist. LEXIS 100837 (S.D.N.Y. June 6, 2022), *aff'd*, 2023 WL 3882697, 2023 U.S. App. LEXIS 14241 (2d Cir. June 8, 2023); *Haymount Urgent Care PC v. GoFund Advance, LLC*, 609 F. Supp. 3d 237, 249 (S.D.N.Y. 2022) (hereafter cited as "*Haymount*"); *New Y-Capp v. Arch Cap. Funding, LLC*, No.18-CV-3223 (ALC), 2022 WL 4813962 (S.D.N.Y. Sept. 30, 2022); *J.P.R. Mech. Inc. v. Radium2 Cap., LLC (In re J.P.R. Mech Inc.)*, No. 19-23480 (DSJ), 2025 WL 1550541, 2025 Bankr. LEXIS 1319 (Bankr. S.D.N.Y. May 30, 2025); *In re Williams Land Clearing, Grading, & Timber Logger, LLC*, No. 22-02094-5-PWM, 2025 WL 1426503 (Bankr. E.D.N.C. May 16, 2025); *In re M Design Vill., LLC*, No. 24-21406 (MEH), 2025 WL 2088887 (Bankr. D. N.J. July 24, 2025); *In re Shoot the Moon, LLC*, 635 B.R. 797 (Bankr. D. Mont. 2021); *LG Funding, LLC, LLC*, 181 A.D.3d at 664, 122 N.Y.S.3d 309.

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United States Bankruptcy Court, D. Idaho.

IN RE: HMH CONSTRUCTION, LLC, Debtor.
Timothy R. Kurtz Plaintiff,
v.
Kalamata Capital Group, LLC, Defendant.

Case No. 23-00191-NGH
|
Adv. No. 25-06027-NGH
|
Signed 01/21/2026

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MEMORANDUM OF DECISION

NOAH G. HILLEN, Chief U.S. Bankruptcy Judge

***1** Timothy Kurtz, the chapter 7 trustee ("Trustee"), initiated this adversary proceeding against Kalamata Capital Group, LLC ("Kalamata"), in April of 2025. Doc. No. 1 (the "Complaint"). Kalamata filed a motion to dismiss the Complaint pursuant to Civil Rule 12(b)(6) [1] for failure to state a claim upon which relief may be granted (the "Motion"). Doc. No. 19. Kalamata filed a brief in support and a declaration. Doc. Nos. 20 & 21. Trustee filed a response. Doc. No. 24. The Court held a hearing on the Motion on December 8, 2025, and took the matter under advisement. After considering the record, arguments, and applicable law, the following constitutes the Court's findings, conclusions, and disposition of the issues.

BACKGROUND

In 2019, Kalamata and HMH Construction, LLC, the debtor in this case, entered into a "Revenue Purchase Agreement" for the purchase and sale of HMH's future receivables (the "Agreement"). Under the Agreement, HMH agreed to sell $158,500 of its accounts receivable to Kalamata in exchange for $120,000. The Agreement authorized Kalamata to withdraw 15% of HMH's revenue weekly, which resulted in a weekly remittance of $5,658. According to the Agreement, this amount was a good faith estimate of the purchased percentage based on HMH's revenues. Section 1.4 allowed HMH to request a retroactive reconciliation, whereby Kalamata would debit or credit the difference "so that the total amount debited by [Kalamata] shall equal the Specific Percentage of the Future Receipts that [HMH] Collected from the date of this Agreement up to and including the date of the Reconciliation request." If applicable, such reconciliation "shall be performed" by Kalamata within five business days following the request. Additionally, section 1.5 provided that "should [HMH] experience a decrease in its Future Receipts, [HMH] may give notice to [Kalamata] to request a decrease in the Remittance," which remittance "shall be modified to more closely reflect [HMH's] actual receipts."

As part of the Agreement, HMH granted Kalamata a security interest in its accounts receivable effective immediately and a security interest in other collateral effective upon default. Performance of the Agreement was guaranteed by HMH's principal, who could be held jointly and severally liable for all amounts owed to Kalamata in the event of HMH's default. If one of the enumerated "Events of Default" occurred, the full uncollected purchased amount would become due and owing immediately and Kalamata could enforce its security interest in the collateral and against the guarantor.

The parties performed under the Agreement without incident. Kalamata transferred $120,000 to HMH and between August 2019 and February 2020, Kalamata collected the weekly remittance from HMH's accounts receivable until it collected the full purchased amount of $158,400. Three years later in April 2023, HMH filed its bankruptcy petition, and two years later, Trustee initiated this adversary proceeding.

***2** Count I of the Complaint seeks declaratory relief that the Agreement is void ab initio under New York law. Count II seeks to avoid the transfers to Kalamata pursuant to § 544 and Idaho Code sections 55-913 and 55-914. Finally, to the extent Kalamata "holds or will file an otherwise valid and enforceable claim," Count III seeks disallowance of said claim pursuant to § 502(d) unless and until Kalamata complies with the requirements therein. Kalamata asserts the Complaint fails to state a claim upon which relief may be granted.

ANALYSIS

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A. Rule 12(b)(6) Standard

Two seminal Supreme Court cases guide the Court's analysis of motions to dismiss under Civil Rule 12(b)(6)—*Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007) and *Ashcroft v. Iqbal*, 556 U.S. 662 (2009). *Twombly* held that to survive a motion to dismiss under 12(b)(6), a complaint must sufficiently allege facts "to raise a right to relief above the speculative level, on the assumption that all the allegations in the complaint are true (even if doubtful in fact)." 550 U.S. at 556. In *Iqbal*, the Supreme Court elaborated:

> To survive a motion to dismiss, a complaint must contain sufficient factual matter, accepted as true, to state a claim to relief that is plausible on its face. A claim has facial plausibility when the plaintiff pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged. The plausibility standard is not akin to a probability requirement, but it asks for more than a sheer possibility that a defendant has acted unlawfully. Where a complaint pleads facts that are merely consistent with a defendant's liability, it stops short of the line between possibility and plausibility of entitlement to relief.

556 U.S. at 678 (internal quotation marks and citations omitted).

In *Hillen v. Specialized Loan Servicing, LLC (In re Leatham)* this Court summarized the standard for dismissal under Civil Rule 12(b)(6) as follows:

> In determining whether a plaintiff has advanced potentially viable claims, the complaint is to be construed in a light most favorable to the plaintiff and its allegations taken as true. When reviewing the allegations of a complaint, legal conclusions, deductions or opinions couched as factual allegations are not given a presumption of truthfulness. The complaint should not be dismissed for a failure to state a claim unless it appears that the plaintiff can prove no set of facts in support of the claim which would entitle plaintiff to relief. Thus, a court may properly grant a Rule 12(b)(6) motion if it is clear from the face of the complaint and judicially-noticed documents that the plaintiff cannot prevail as a matter of law.
>
> ... [T]he issue is not whether a plaintiff will ultimately prevail but whether he is entitled to offer evidence in support of the claims. It may appear on the face of the pleadings that recovery is very remote and unlikely, but that is not the test. The key is whether or not it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief.

2017 WL 3704512, at *1 (Bankr. D. Idaho Aug. 24, 2017).

Dismissal under Civil Rule 12(b)(6) may "be based on either the lack of a cognizable legal theory or on the absence of sufficient facts alleged under a cognizable legal theory." *Tracht Gut, LLC v. Los Angeles Cnty. Treasurer & Tax Collector (In re Tracht Gut, LLC)*, 836 F.3d 1146, 1151 (9th Cir. 2016). If there is merit to a 12(b)(6) motion, Ninth Circuit authority restricts a court's ability to dismiss a case and instead requires the court to provide a complainant leave to amend the complaint "unless it is clear that the complaint could not be saved by any amendment." *Harris v. Amgen, Inc.*, 573 F.3d 728, 736 (9th Cir. 2009) (internal quotation marks omitted).

B. Claims for Relief

1. Count I: Declaratory Relief

***3** As noted, Trustee seeks declaratory relief that the Agreement is void ab initio under New York's usury statute. The Agreement contains a New York choice-of-law provision, which the parties do not dispute. Under New York General Obligation Law § 5-512, a corporation may not assert a defense of usury in any action except "criminal usury as described in section 190.40 of the penal law." The Complaint alleges that although the Agreement does not carry an interest rate on its face, its terms effectively result in an interest rate that exceeds the criminal usury rate of 25%. And, as such, the Agreement is void ab initio. Kalamata argues dismissal is appropriate because Trustee cannot bring an affirmative claim for relief under New York's usury statute and, even if Trustee were able to bring such a claim, usury does not apply because the Agreement represents a sale, not a loan.

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a. Existence of a Loan

Before a court can assess whether a contract is usurious, there must be a "loan or forbearance of money and where there is no loan there can be no usury." *Guttman v. EBF Holdings, LLC (In re Glob. Energy Sevrs., LLC)*, 2025 WL 1012721, at *3 (Bankr. D. Md. Mar. 31, 2025) (quoting *IBIS Cap. Grp., LLC v. Four Paws Orlando LLC*, 2017 WL 1065071, at *1 (N.Y. Sup. Ct. Mar. 10, 2017)). *See Streamlined Consultants, Inc. v. EBF Holdings LLC*, 2022 WL 4368114, at *4 (S.D.N.Y. Sept. 20, 2022) (noting "rudimentary element of usury is existence of loan or forbearance") (citing *Colonial Funding Network, Inc. v. Epazz, Inc.*, 252 F. Supp. 3d 274, 280 (S.D.N.Y. 2017)). "When determining whether a transaction is a usurious loan it must be considered in its totality and judged by its real character, rather than by the name, color, or form which the parties have seen fit to give it." *Streamlined Consultants, Inc.*, 2022 WL 4368114, at *4 (citation omitted). The key consideration is the transfer of risk, with the hallmark being that an alleged lender is "absolutely entitled to repayment under all circumstances." *Id.* (quoting *Principis Cap., LLC v. I Do, Inc.*, 160 N.Y.S.3d 325, 326-27 (N.Y. App. Div. 2022)). Unless repayment is absolute, the transaction is not a loan. *Id.*

Three factors generally inform whether repayment is absolute or contingent, namely: "(1) whether there is a reconciliation provision in the agreement; (2) whether the agreement has a finite term; and (3) whether there is any recourse should the merchant declare bankruptcy." *Fleetwood Servs., LLC v. Ram Cap. Funding, LLC*, 2022 WL 1997207, at *9 (S.D.N.Y. June 6, 2022) (quoting *LG Funding, LLC v. United Senior Props. of Olathe, LLC*, 122 N.Y.S.3d 309, 312 (N.Y. App. Div. 2020)). *See also Guttman v. EBF Holdings, LLC (In re Glob. Energy Sevrs., LLC)*, 2025 WL 1012721, at *4 (Bankr. D. Md. Mar. 31, 2025) (discussing role of factors in assessing absolute repayment noting "by an overwhelming majority, courts apply the *LG Funding* non-exhaustive three-factor test" to cases involving merchant cash advance agreements). These factors serve as a guide and do not "dictate the conclusion, and a court need not find the presence of all three factors in concluding that a transaction is a loan." *Fleetwood Servs., LLC*, 2022 WL 1997207, at *9 (collecting cases). Additionally, the factors are non-exhaustive and other factors may bear on the true nature of a transaction.

i. Presence of Reconciliation Provision

"A reconciliation provision is relevant because it can shift the risk of nonpayment away from the merchant by 'allow[ing] the merchant to seek an adjustment of the amounts being taken out of its account based on its cash flow (or lack thereof).' " *Fleetwood Servs., LLC*, 2022 WL 1997207, at *9 (citing *K9 Bytes, Inc. v. Arch Cap. Funding, LLC*, 57 N.Y.S.3d 625, 632 (N.Y. Sup. Ct. 2017)) (alteration in original). However, the mere presence of a reconciliation provision is not dispositive. Reconciliation that is illusory or effectively impracticable weighs in favor of the transaction being a loan. For example, reconciliation may be illusory if the sum to be withdrawn is not a percentage but a specific amount regardless of whether any accounts receivables are collected, and reconciliation or adjustment of the amount to be withdrawn is left to the sole discretion of the alleged purchaser. *Id.* at *10 (citing *Am. Water Restoration, Inc. v. AKF Inc.*, 157 N.Y.S.3d 919 (N.Y. Sup. Ct. 2002)). *See also US Info. Grp. LLC v. EBF Holdings, LLC*, 2023 WL 6198803, at *7 (S.D.N.Y. Sept. 22, 2023) (collecting cases in which reconciliation was unduly onerous or had a "sham quality"). "By contrast, an enforceable reconciliation provision, pursuant to which payment is to be adjusted according to the seller's actual receipts, is generally inconsistent with classification as a loan subject to the usury laws." *Id.* at *8.

***4** Here, the Agreement contained a reconciliation provision and an avenue by which HMH could reduce the remittance amount to reflect its actual receipts. Unlike the provision in *Fleetwood Services*, reconciliation and remittance adjustments are mandatory upon HMH's request and not left to Kalamata's discretion. In other words, the Agreement's reconciliation and remittance provisions state that Kalamata "shall" reconcile or adjust the remittance. Nonetheless, Trustee alleges that reconciliation is illusory because Kalamata withdrew remittances without regard to HMH's actual receipts and at times when HMH had no receipts, and section 1.4 does not require Kalamata to modify the weekly remittance to reflect HMH's actual receipts. However, the remittance adjustment provision in section 1.5 allows for modification of the weekly withdrawal, and Trustee does not allege these provisions did not function as agreed. *See Streamlined Consultants, Inc. v. EBF Holdings LLC*, 2022 WL 4368114, at *4 (S.D.N.Y. Sept. 20, 2022) (noting merchant did not allege reconciliation did not function as agreed "or, indeed, that [merchant] ever even requested reconciliation").

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Trustee also alleges HMH had committed events constituting default at the time it executed the Agreement and Kalamata could therefore have invoked its rights against HMH and the guarantor at any time. The Court observes that reconciliation and remittance adjustment are available to HMH only so "long as an Event of Default, or breach of this Agreement, has not occurred." Trustee cites section 2.10 of the Agreement as one example of default. Under section 2.10, HMH represented, warranted, and covenanted that, "as of the date and during the term of this Agreement":

> [HMH] has good, complete, unencumbered and marketable title to all Receipts, free and clear of any and all liabilities, liens, claims, changes, restrictions, conditions, options, rights, mortgages, security interests, equities, pledges and encumbrances of any kind or nature whatsoever or any other rights or interests that may be inconsistent with the transactions contemplated with, or adverse to the interests of [Kalamata].

Section 3.1 outlines events constituting default, including a "violation of any term of covenant of the Agreement" and "[a]ny representation or warranty by [HMH] in this Agreement shall prove to have been incorrect, false or misleading in any material respect when made." The Complaint alleges other entities filed financing statements with the Idaho Secretary of State against HMH and certain assets of HMH prior to the execution of the Agreement. And "[w]hen Kalamata provided the funds ... it was either aware of, or could have readily ascertained, the existence of multiple liens, including the previous lien rights of other creditors, that were outstanding at the time and superior to Kalamata's alleged lien claim." *See* Doc. No. 1 ¶ 14. Kalamata's failure to exercise its rights in the face of HMH's default does not constitute a waiver and section 4.1 would require any waiver to be in writing. *Id*. ¶ 46. Therefore, despite appearing enforceable and mandatory, HMH may have been prevented from utilizing the reconciliation and remittance adjustment provisions as written.

ii. Indefinite or Finite Term

The second factor is whether the transaction contains a finite term by which the alleged seller must transmit the purchased receivables to the buyer, which would suggest the transaction was not a true sale but a loan. "This factor goes hand-in-glove with the reconciliation provision factor." *Guttman v. EBF Holdings, LLC (In re Glob. Energy Servs., LLC)*, 2025 WL 1012721, at *5 (Bankr. D. Md. Mar. 31, 2025). If the amount due is subject to change via reconciliation or adjusted remittances, the "term of the agreement is necessarily not finite." *Fleetwood Servs., LLC*, 2022 WL 1997207, at *9 (citing *Principis Cap., LLC v. I Do, Inc.*, 160 N.Y.S.3d 325, 327 (N.Y. App. Div. 2022)). Here, the Agreement provides there is no "payment schedule and no time period during which the Purchased Amount must be collected by [Kalamata]." And in theory, had HMH requested an adjustment to the remittance or reconciliation, Kalamata's collection would have varied according to HMH's receipts, thereby potentially extending the term of the Agreement indefinitely. Nonetheless, Trustee alleges the Agreement carried a de facto term for repayment that was fixed by the weekly remittance amount because there was no true right to reconciliation.

iii. Recourse in the Event of Bankruptcy

***5** The third factor considers whether Kalamata had any recourse in the event HMH filed a bankruptcy petition. "In determining whether the merchant retains the risk of nonpayment, it is significant that 'the agreement provides that [defendant's] written admission of its inability to pay its debt or its bankruptcy constitute events of default under the agreement, which entitle the plaintiff to the immediate full repayment of any of the unpaid purchased amount.' " *Fleetwood Servs., LLC*, 2022 WL 1997207, at *9 (quoting *LG Funding, LLC v. United Senior Props. of Olathe, LLC*, 122 N.Y.S.3d 309, 313 (N.Y. App. Div. 2020)). Recourse in the event of bankruptcy suggests the seller's obligation to the purchaser is "absolute and not contingent on its actual accounts receivable," and is thus a loan. *Id.*

The Agreement does not list filing a bankruptcy petition as an event of default. Additionally, the Agreement provides: "[HMH] going bankrupt or going out of business, or experiencing a slowdown in business, or a delay in collecting its receivables, in and of itself, does not constitute a breach of this Agreement." Courts considering similar terms have determined they weigh in favor of finding the risk lies with the purchaser, not the seller, and the contract is truly a sale. *See*

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Guttman v. EBF Holdings, LLC (In re Glob. Energy Servs., LLC), 2025 WL 1012721, at *6 (Bankr. D. Md. Mar. 31, 2025) and *Streamlined Consultants, Inc. v. EBF Holdings LLC*, 2022 WL 4368114, at *5 (S.D.N.Y. Sept. 20, 2022). However, in the event of HMH's default, the uncollected purchased amount plus fees would become due and payable immediately and Kalamata could enforce its rights under the Agreement against HMH and the guarantor, which is more indicative of a loan. Moreover, Trustee asserts filing a petition for relief constitutes HMH's transfer of all or substantially all of its assets, which does constitute an event of default, thereby entitling Kalamata to immediate full repayment of any unpaid amounts and securing Kalamata's right to repayment in the event HMH filed a bankruptcy petition.

iv. Other Factors

The *LG Funding* factors are not dispositive, and other factors may inform whether the transaction represents a genuine transfer of risk "or if the agreement is structured to ensure an absolute repayment obligation." *Reserve Funding Grp. LLC v. California Organic Fertilizers, Inc.*, 2024 WL 1604195, at *2 (E.D.N.Y. Apr. 12, 2024) (citing *Haymount Urgent Care PC v. GoFund Advance, LLC*, 609 F. Supp. 3d 237, 247 (S.D.N.Y. 2022)). For example, an agreement that allocates risk to the seller while affording the purchaser a "panoply of rights, remedies, and potential control is highly unusual in the context of an assets sale," and "[s]uch an overall arrangement is consistent with a debtor-creditor relationship, not a seller-buyer relationship." *Cap Call, LLC v. Foster (In re Shoot the Moon, LLC)*, 635 B.R. 797, 817 (Bankr. D. Mont. 2021).

In certain respects, the Agreement appears to allocate risk to Kalamata. It states Kalamata entered into the transaction "knowing the risks that [HMH's] business may slow down or fail," and all payments to Kalamata "shall be conditioned upon [HMH's] sale of products and services, and the payment therefore by [HMH's] customers." However, section 1.2 provides the Agreement "shall remain in full force and effect until the entire Purchased Amount and any other amounts due are received by [Kalamata]," and the security agreement granted Kalamata a security interest in all of HMH's assets, beyond the accounts receivable, "if at any time there are insufficient funds in [HMH's] Account to cover Kalamata's entitlements under this Agreement." Additionally, Kalamata maintained extensive rights and remedies in the event of HMH's breach or default, including appointment as power of attorney, a security interest in all HMH's assets, the right to enter a confession judgment against HMH for the purchased amount, automatic assignment of HMH's business leases, and the right to immediately enforce its security interests and collect the sums due under the Agreement from HMH and/or the guarantor.

***6** Trustee alleges the Agreement functioned as a loan because it provided Kalamata with recourse to sources beyond the receivables and as discussed above, HMH was in default upon execution and Kalamata knew of such default. Therefore, there was no true transfer of risk to Kalamata that HMH's business would slow down, fail, or HMH's customers would not pay.

Construing the Complaint in a light most favorable to Trustee and accepting all factual allegations as true, the Complaint adequately pleads that the Agreement may in actuality function as a loan, not a sale.

b. Availability of Affirmative Relief

Kalamata asserts that even if Trustee could prove the Agreement was a loan, Trustee cannot seek affirmative relief under New York's usury laws. "Under New York's usury statute, where the interest rate on a debt exceeds the criminal usury rate of 25% per annum, 'a corporation may interpose an affirmative defense of usury and, if successful, obtain a declaration that invalidates the debt instrument ab initio.' " *Streamlined Consultants, Inc. v. EBF Holdings LLC*, 2022 WL 4368114, at *3 (S.D.N.Y. Sept. 20, 2022) (citing *Haymount Urgent Care PC v. GoFund Advance, LLC*, 609 F. Supp. 3d 237, 254 (S.D.N.Y. 2022)). However, this statute is limited to an affirmative defense, and corporations may not raise affirmative claims or counterclaims alleging criminal usury in order to invalidate an agreement. *Id. See also Intima-Eighteen, Inc. v. A.H. Schreiber Co., Inc.*, 568 N.Y.S.2d 802, 804 (N.Y. App. Div. 1991) ("The statutory exception for interest exceeding 25 percent per annum is strictly an affirmative defense to an action seeking repayment of a loan and may not, as attempted here, be employed as a means to effect recovery by the corporate borrower."); *Paycation Travel, Inc. v. Global Merch. Cash, Inc.*, 141 N.Y.S.3d 319, 320 (N.Y. App. Div. 2021) (exception for criminal usury is "only as a defense to an action to recover repayment of a loan, and not as the basis for a cause of action asserted by the corporation for affirmative relief").

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Therefore, to the extent Trustee seeks to use the New York usury statute as a sword to void the Agreement or as a means to effect recovery, the Complaint fails to state a claim upon which relief may be granted and Count I will be dismissed without leave to amend. However, insofar as Trustee seeks a judicial determination that the Agreement is a usurious loan as it may concern Trustee's other claims, the Court will grant Trustee leave to amend the Complaint to clarify the relief sought. [2]

2. Count II: Transfer Avoidance

The Complaint seeks avoidance of the transfers to Kalamata under § 544(b) and Idaho law. Section 544(b) provides "the trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim." Trustee seeks to avoid the transfer of the receivables under the Idaho Uniform Voidable Transfers Act ("UVTA"). In particular, Trustee cites Idaho Code sections 55-913 and 55-914.

***7** "A prerequisite to both I.C. § 55-913 and § 55-914 is the presence of creditors who had antecedent debts at the time of the transfer." *Geile v. Wickersham (In re Gray)*, 2023 WL 4163465, at *2 (Bankr. D. Idaho June 23, 2023) (citing *Parkinson Seed Farm, Inc. v. Arlo Weeks & Brookside, LLC (In re Parkinson Seed Farm, Inc.)*, 640 B.R. 218, 250 (Bankr. D. Idaho 2022)). The Complaint alleges HMH had multiple unsecured creditors at the time the obligation was incurred and the transfers made, including the IRS, who "would have been able to pursue recovery of the transfers under relevant non-bankruptcy law." Additionally, the Complaint alleges that at all times, the assets of HMH, including the accounts receivable, were property of HMH and subject to valid security interests of other parties. While claims under these sections are normally subject to a four-year limitations period, Trustee contends the IRS is among the unsecured creditors who could have pursued recovery, and this Court has held that a trustee standing in the shoes of the IRS is not restricted by the state-law transfer limitations periods. *See Hillen v. City of Many Trees, LLC (In re CVAH, Inc.)*, 570 B.R. 816, 835-36 (Bankr. D. Idaho 2017).

Idaho Code section 55-914(1) provides:

> A transfer made or obligation incurred by a debtor is voidable as to a creditor whose claim arose before the transfer was made or the obligation was incurred if the debtor made the transfer or incurred the obligation without receiving a reasonably equivalent value in exchange for the transfer or obligation and the debtor was insolvent at that time or the debtor became insolvent as a result of the transfer or obligation.

And, under Idaho Code section 55-913(1),

> a transfer made or obligation incurred by a debtor is voidable as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation: (a) [w]ith actual intent to hinder, delay, or defraud any creditor of the debtor.

Idaho Code section 55-913(2) enumerates several factors to consider in determining whether a party acted with actual intent, including whether the "value of consideration received by the debtor was reasonably equivalent to the value of the asset transferred or amount of obligation incurred" and the "debtor was insolvent or became insolvent shortly after the transfer was made or the obligation as incurred."

Here, the Complaint alleges HMH incurred the obligation and made transfers to Kalamata in the amount of $158,400 without receiving fair consideration because the Agreement allegedly carried a usurious interest rate. Additionally, at the time the obligations were incurred and transfers made, "the present fair market value of [HMH's] assets were less than the amount required to pay its probable liability on its existing debts as they became absolute and matured," i.e., HMH was insolvent "as that term is defined in 11 U.S.C. § 101(32) and applied in 11 U.S.C. §§ 547 and 548, as well as defined in Idaho Code § 55-911 and applied in 11 U.S.C. § 544."

Accepting all factual allegations as true, the Complaint states a claim for relief that the transaction is avoidable under state law and § 544(b).

3. Claim III: Disallowance of Claim Under § 502(d)

Finally, Trustee seeks claim disallowance under § 502(d). Section 502(d) provides: "Notwithstanding subsections (a) and (b) of this section, the court shall disallow any claim of any entity ... that is a transferee of a transfer avoidable under section ... 544 ... of this title, unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable under section 522(i), 542, 543, 550, or 553 of this title." Kalamata argues the claim should be dismissed as moot because the Agreement was not a loan, and, as such, Trustee cannot avoid the transfers, and Kalamata has no need to file a proof of claim. However, the Complaint adequately pleads the potential existence of a loan and avoidance. Accordingly, it remains possible Kalamata files a claim pursuant to Rule 3002. Therefore, Claim III is not moot.

CONCLUSION

***8** For the reasons set forth above, the Court will grant Kalamata's motion to dismiss Count I to the extent it seeks to assert New York's usury statute as a sword, but it will grant Trustee leave to amend Count I to clarify the relief sought. The Court will deny Kalamata's motion to dismiss with respect to Counts II and III. The Court will enter its own order.

All Citations

Slip Copy, 2026 WL 171515

Footnotes

1 Unless otherwise indicated, all chapter and section references are to the Bankruptcy Code, 11 U.S.C. §§ 101–1532, all "Rule" references are to the Federal Rules of Bankruptcy Procedure, Rules 1001–9038, and all "Civil Rule" references are to the Federal Rules of Civil Procedure.

2 Seeking to distinguish the present case at the hearing, Trustee noted he is standing in the shoes of a creditor, not those of the corporate borrower. To the extent it is relevant to the relief sought, the Court questions whether a creditor who is not party to the contract may claim the protections of New York's usury laws. *See Seidel v. 18 East 17th Street Owners, Inc.*, 586 N.Y.S.2d 240, 243 (N.Y. App. Div. 1992) (collecting cases and observing "under certain circumstances, a stranger to the loan has no standing to claim that it was usurious").

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635 B.R. 797
United States Bankruptcy Court, D. Montana.

IN RE: SHOOT THE MOON, LLC, Debtor.
Cap Call, LLC, Plaintiff and Counterclaim-defendant,
v.
Jeremiah J. Foster, Defendant and Counterclaim-plaintiff.

Case No. 2:15-bk-60979-WLH
|
Adv. Proc. No. 2:17-ap-00028-WLH
|
Signed September 10, 2021.

Synopsis

Background: Merchant cash advance company that provided prepetition financing to Chapter 11 debtor, a limited liability company (LLC) that operated numerous restaurants, filed adversary complaint against Chapter 11 trustee, seeking declaratory relief that it owned remaining balance in segregated account into which certain restaurant customer credit card payments had been deposited, judgment against trustee for converting postpetition receipts, and other miscellaneous fees, costs, and interest. Trustee filed counterclaim seeking, inter alia, declaratory relief that the parties' transactions were disguised loans, not sales, unencumbered title to segregated account, avoidance and recovery of allegedly preferential transfers, and remedies stemming from company's alleged usurious interest rates. Trial was held.

Holdings: The Bankruptcy Court, Whitman L. Holt, J., held that:

trustee had standing to pursue his declaratory relief claims;

under either Montana or New York law, the transactions at issue were loans, not sales;

under "federal" choice-of-law rules, the law of Montana, not New York, governed trustee's usury claim;

company violated Montana usury law, entitling trustee to judgment in the amount of $1,216,685;

trustee established his preference claim with respect to funds received by company within 90 days immediately preceding the petition date on account of its loans to debtor entities;

company was not entitled to the receivables in the segregated account;

adversary proceeding involved an action "on the contract" and, thus, trustee was entitled to award of attorney fees against company pursuant to Montana's reciprocal fee statute; and

under the circumstances, a reasonable fee consisted of 30% of balance of segregated funds, 20% of amount of Montana usury penalty, and 10% of amount of avoided preferential transfers, for total award of $424,756.58.

Judgment for trustee.

Procedural Posture(s): Request for Declaratory Judgment.

Attorneys and Law Firms

***804** Martin S. King, Worden Thane, P. C., Missoula, MT, Alissa a Brice Castaneda, W. Scott Jenkins, Jr., Quarles & Brady LLP, Phoenix, AZ, for Counter-Claimant.

David B. Cotner, Missoula, MT, for Defendant.

Michael H. Hekman, Robert C. Lukes, Garlington, Lohn & Robinson, PLLP, Missoula, MT, Roland Gary Jones, New York, NT, Steven M. Johnson, Great Falls, MT, for Plaintiff.

MEMORANDUM OPINION

WHITMAN L. HOLT, U.S. BANKRUPTCY JUDGE

Legal relationships between private parties are largely defined by contract. When these contracts are implicated in litigation, courts must assess the terms and other relevant evidence to classify and determine the parties' rights and liabilities, often months or years after the original deal. In some instances, this after-the-fact analysis reveals legally significant aspects of the contractual relationship that the parties might not have appreciated when contracting.

In this adversary proceeding, a bankruptcy trustee and CapCall, LLC disagree about the legal classification and ramifications of prepetition transactions. After fully considering the evidence presented at trial, as well as briefing

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and oral argument offered by both sides, the court has determined that the trustee is entitled to entry of a judgment against CapCall. The details follow below. [1]

FACTUAL BACKGROUND & PROCEDURAL POSTURE

The Shoot the Moon Enterprise Generally

In the early 2000s, Kenneth Hatzenbeller and two other principal investors created a business generally known as Shoot the Moon. Over time this enterprise grew ***805** to consist of nineteen LLCs formed pursuant to Idaho, Montana, and Washington law that owned and operated sixteen restaurants located throughout the three states. [2] Among other forms of customer payment, the restaurants accepted credit cards, which generated a revenue stream for the Shoot the Moon entities through a processing company called Heartland Payment Systems, Inc. [3] Until shortly before the underlying Shoot the Moon bankruptcy case discussed later, Mr. Hatzenbeller exercised day-to-day management and control of all Shoot the Moon entities from his office in Great Falls, Montana.

The Shoot the Moon restaurants eventually encountered various financial pressures, including due to the 2007-2009 Great Recession and improvements demanded by some of the restaurants' franchisors. Hoping to combat these pressures, Mr. Hatzenbeller sought additional financing from various sources. Initial sources included himself and the original investors, family and friends, additional third-party investors, traditional bank lenders, and trade creditors. Some creditors obtained and perfected security interests regarding all assets of various of the entities (including accounts receivable) via UCC-1 financing statements that predate the CapCall transactions. [4]

Prepetition Merchant Cash Transactions With CapCall, LLC

Once the Shoot the Moon entities exhausted the sources of capital mentioned above, several sought additional financing from merchant cash advance companies such as CapCall. Between October 2014 and September 2015, the Shoot the Moon entities and CapCall consummated eighteen transactions. The parties detailed the terms in written Merchant Agreements and associated documents (including confessions of judgment, personal guaranties by Shoot the Moon's principals, and UCC-1 financing statements). [5] The Merchant Agreements are generally similar but contain minor variations.

The economic core of these transactions was that CapCall provided the Shoot the Moon entities with immediate cash (and hence liquidity to operate) upon closing. In exchange, CapCall received a portion of future receivables generated through the restaurant operations. The amounts promised to CapCall substantially exceeded the amount of cash CapCall paid, which created possible profit for CapCall and represented the cost to the Shoot the Moon entities of obtaining financing in this fashion.

Return transfers to CapCall were effected via fixed daily ACH debits (in the "Specified Daily Amount" per each agreement) against bank accounts Mr. Hatzenbeller specified. The debits continued regarding a given agreement until CapCall received a total "Receipts Purchased Amount" set forth in that agreement. A significant majority of the transfers were made using the bank account of an entity – Shoot the Moon Grizzly, LLC – that was not party to any of the agreements and did not operate any restaurants generating ***806** receivables. [6] Jason Leak, the primary representative of CapCall, knew about this mismatch between the contractual counterparty entities and the entity used to fund payments. Mr. Leak expressed no concern other than to request that there was "an account that will clear all the time." [7]

Mr. Hatzenbeller and Mr. Leak arranged each transaction via email. [8] In these emails, the two primarily addressed the amount CapCall would advance to a particular Shoot the Moon entity. Before funding, Mr. Leak emailed Mr. Hatzenbeller legal documents for signature – CapCall apparently never countersigned any of the agreements. CapCall and each specific entity documented each transaction via a separate, standalone Merchant Agreement. CapCall selected the terms and conditions of these agreements by using its form documents; Mr. Hatzenbeller testified that the two negotiated no specific terms beyond the basic economics and that he in fact did not read the documents before signing them. Although Mr. Leak occasionally suggested to Mr. Hatzenbeller that he could obtain regular financing, there was no binding commitment to lend or make future advances and each new transaction was subject to separate investor approval and documentation. [9] Emails between Mr. Hatzenbeller and Mr. Leak often referred to the transactions as "loans" or "notes" and on at least one occasion, there

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was specific negotiation regarding the temporal "term" of a transaction. [10]

The Shoot the Moon Bankruptcy Generally

On October 20, 2015, all nineteen Shoot the Moon entities merged into Shoot the Moon, LLC. [11] The following day, this entity filed the underlying chapter 11 bankruptcy petition here. [12]

During the bankruptcy case, Jeremiah J. Foster (the "Trustee") was appointed as the chapter 11 trustee and then as trustee of the STM Liquidating Trust pursuant to the confirmed chapter 11 plan. [13]

For purposes of this dispute, material events during the course of the bankruptcy case include:

- The Trustee sold substantially all of the bankruptcy estate's business assets via Bankruptcy Code section 363(b). The net proceeds realized from this sale were substantially less than the amount of the claims of numerous secured creditors (including ***807** those with perfected security interests senior to CapCall), leaving them with significant unsecured deficiency claims under Bankruptcy Code section 506(a). [14] CapCall did not object to the sale or to a stipulation regarding distribution of the proceeds to certain of the senior secured creditors.

- The Trustee moved to obtain turnover of certain funds held by Heartland consisting of restaurant customer credit card payments processed prepetition but not transferred to any Shoot the Moon accounts before the petition date. [15] The Trustee and CapCall subsequently stipulated to segregate these funds pending resolution of the parties' disputes. The balance is $228,449.93. [16]

- CapCall filed a proof of claim asserting a claim for conversion of receivables that CapCall contended it owned. CapCall acknowledged that the claim was unsecured and that CapCall held no security interest in property of the debtor. [17]

Posture of This Adversary Proceeding

In August 2017, CapCall commenced this adversary proceeding. CapCall seeks declaratory relief that it owns the remaining balance deposited in the segregated account, a judgment against the Trustee for converting postpetition receipts, and other miscellaneous fees, costs, and interest components. The Trustee counterclaimed seeking declaratory relief about which state's law applies to the transactions and that the transactions are disguised loans rather than sales. The Trustee also seeks unencumbered title to the segregated account, avoidance and recovery of allegedly preferential transfers, and remedies stemming from CapCall's alleged usurious interest rates.

The court conducted a trial commencing June 29, 2021, and concluding the following day. At trial, the court admitted numerous exhibits and deposition excerpts. [18] The parties presented the following testimony:

- **Evan Marmott**. Mr. Marmott is the CEO and owner of CapCall. He testified about the general nature of CapCall's business and his understanding of how the Merchant Agreements operate, including features of the documents that he believes are standard industry practice. Mr. Marmott testified about the due diligence CapCall did before entering into transactions, including reviewing account statements from the credit-card payment processer and checking Mr. Hatzenbeller's credit report. Mr. Marmott conceded on cross-examination that he had no direct personal contact with Mr. Hatzenbeller and that such interactions occurred with CapCall's "outside brokers" such as Mr. Leak. Aside from this basic background information, the court did not find Mr. Marmott credible or persuasive. He was often evasive, his description of the relationship between CapCall and the Shoot the Moon entities was largely conclusory and self-serving (and hearsay due to his lack of interaction with Mr. Hatzenbeller), and ***808** his description of the Merchant Agreements frequently conflicted with the plain terms of the documents. For example, Mr. Marmott adamantly disclaimed the expansive scope of the collateral package granted to CapCall in the documents despite being shown the specific and unambiguous language.

- **Jeremiah Foster**. The Trustee testified about his experience as a turnaround professional and his involvement with the Shoot the Moon entities. Mr. Foster explained that Western Alliance Bank brought him into the situation, that he participated in a pre-bankruptcy meeting of creditors, and that he then became chapter 11 trustee. Mr. Foster detailed the section 363(b) sales process he coordinated, the resolution regarding distribution of the proceeds to various secured creditors (specifically noting the reasons CapCall was

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not invited to participate in the settlement process and that CapCall received notice but did not object to the final resolution), and the shift into a litigation mode. Overall, the court found Mr. Foster professional and credible. His testimony provided helpful context about events occurring during the bankruptcy case.

- **Nicole Manos**. Ms. Manos is a Senior Managing Director of Resolute, a financial services firm headed by Mr. Foster and retained to provide litigation support and financial advisory services to the Trustee. The Trustee offered Ms. Manos as an expert witness regarding the Shoot the Moon entities' financial condition and transactions. CapCall did not file a *Daubert* motion or otherwise challenge Ms. Manos' qualifications. Ms. Manos explained that she reviewed the assets and liabilities of the Shoot the Moon entities and concluded all relevant entities were insolvent both individually and collectively. [19] Ms. Manos further testified that she reviewed the entities' bank statements and prepared a schedule of transfers made to or for the benefit of CapCall within the 90 days prior to the petition date. [20] Based on the premise that the transactions at issue constitute loans governed by Montana law, Ms. Manos also detailed her analysis used to compute the imputed interest rate of the loans and the applicable usury penalty. [21] Ms. Manos also analyzed whether prepetition transfers to CapCall allowed it to receive more than if the Shoot the Moon entities liquidated in chapter 7. Based on a valuation of the Shoot the Moon entities' assets and the existence of various creditors with undersecured liens, but still senior to CapCall, Ms. Manos' analysis revealed that: (i) CapCall received a greater recovery than possible in a hypothetical chapter 7 case absent the transfers and (ii) CapCall has no viable security interest in the receivables the Trustee allegedly converted or in the segregated funds. Overall, the court found Ms. Manos clear and credible. Ms. Manos' written materials and supporting testimony appear both comprehensive and easy to comprehend.

*809 - **Kenneth Hatzenbeller (testimony via Zoom)**. Mr. Hatzenbeller is one of the founders and former manager of Shoot the Moon. He testified about the general history of the business and how he ended up dealing with merchant cash advance parties and CapCall specifically. Mr. Hatzenbeller described his understanding of the CapCall transactions and discussed his interactions with Mr. Leak regarding new transactions. Mr. Hatzenbeller explained how the transactions evolved into a series of "stacked" or "rolled" contracts whereby a portion of CapCall's later advances were used to pay off obligations from earlier agreements. [22] Mr. Hatzenbeller outlined how he used the bank account of a defunct entity, Shoot the Moon Grizzly, LLC, as a central clearinghouse to fund payments for various other Shoot the Moon entities, including to CapCall. Mr. Hatzenbeller detailed how the individual transactions with CapCall were not negotiated, but instead were "take-it-or-leave-it" deals offered using form documents Mr. Leak emailed; Mr. Hatzenbeller explained that he would look at the topline economic terms but otherwise did not read the contracts before signing. Mr. Hatzenbeller acknowledged that he pled guilty for certain crimes relating to Shoot the Moon, but noted that he served his prison sentence and that the criminal activities were unrelated to anything involving CapCall. On cross-examination, Mr. Hatzenbeller admitted that he made bad decisions as manager of the Shoot the Moon entities and that he could have had legal counsel review the CapCall contracts but chose not to. Mr. Hatzenbeller further testified that funds received from CapCall were commingled and used to pay expenses across the entire Shoot the Moon enterprise, although he noted on redirect that he recorded movement of money across different entities via intercompany payables and receivables. [23] Overall, the court found Mr. Hatzenbeller sincere and genuinely contrite about events that occurred during his management of the Shoot the Moon entities, including regarding the CapCall transactions.

After trial, the court requested written submissions regarding several specified issues and heard closing argument. The matter is now ready for decision.

LEGAL ANALYSIS

Jurisdiction & Power

The court has subject matter jurisdiction regarding this adversary proceeding pursuant to 28 U.S.C. §§ 1334(b) & 157(a) and Standing Order No. DLC-43 (D. Mont. Jan. 16, 2019). This court is a proper venue for this litigation as a result of the pendency of the underlying Shoot the Moon bankruptcy case in this district. [24] Previous orders entered in this adversary proceeding reflect the parties' agreement

that this is a "core" proceeding as well as each side's express consent to a final adjudication by this bankruptcy court. [25] Accordingly, ***810** the court may properly exercise the judicial power necessary to finally decide this dispute. [26]

Constitutional & Other Standing Issues

In its post-trial submission, CapCall maintains that the Trustee lacks standing to pursue its declaratory relief claims. [27] The thrust of the argument is not clear, but CapCall appears to contend that the Trustee's claims are predicated on past, not recurring or "prospective," injuries and that the legal issues are not sufficiently related to a cause of action separately supporting federal jurisdiction. Although CapCall's counsel declined to press the point during closing argument, because CapCall frames things as at least partially a matter of "constitutional standing" implicating this court's jurisdiction, the court is compelled to address this threshold consideration. [28] For the reasons set forth below, the court concludes that the Trustee possesses the requisite standing.

To begin, this litigation involves an obvious case or controversy in which the Trustee has standing generally. The Trustee's counterclaims (1) are based on an injury in fact that is concrete and particularized insofar as the Trustee, on behalf of the bankruptcy estate, seeks to recover for allegedly usurious payments made to CapCall and to avoid and recover allegedly preferential transfers made to or for the benefit of CapCall; (2) stem from an injury that is directly traceable to the challenged actions of CapCall insofar as CapCall is the transactional counterparty of the Shoot the Moon entities and transferee of the challenged transfers; and (3) are causes of action as to which it is highly likely that the injury will be redressed by a favorable decision insofar as the court can enter a monetary judgment against CapCall. In short, this litigation involves particularized and non-theoretical claims against CapCall for losses that can be redressed by a decision for the Trustee, which provides Article III standing. [29]

More specifically, in the present context the Trustee may appropriately seek a judicial determination whether the transactions at issue were sales or loans – a question the Trustee frames as declaratory relief. [30] Indeed, this is a predicate question requiring resolution en route to the court's determination of the Trustee's preference claims – claims arising under the Bankruptcy Code. As discussed in detail later, ***811** without classifying the transactions as the Trustee requests, the court cannot determine whether payments made to CapCall on account of the transactions were preferences. Notably, while CapCall now contends that the Trustee lacks standing to seek declaratory relief on this question, CapCall asks the court to resolve the very same issue. In its own amended complaint, CapCall seeks the same relief in order to address whether CapCall's purported purchase of the receivables entitles it to funds currently held in the segregated account and those the Trustee allegedly converted. CapCall fails to reconcile the discrepancy.

Further, like the classification issue, the court must determine whether Montana law applies to the transactions to resolve the Trustee's usury claim.

In sum, CapCall provides no basis (and the court sees none) to conclude that standing principles prevent the Trustee from pressing issues central to the outcome of this litigation, even if these issues are not technically cognizable as standalone causes of action under the Declaratory Judgment Act. [31] Thus, the court concludes that there is no "standing" issue here, constitutional or otherwise. [32]

Classification of the Transactions as True Sales or Loans

As mentioned, the parties disagree about the legal classification of the transactions at issue: CapCall argues they are sales and the Trustee contends they are loans. If sales, CapCall acquired absolute ownership of the subject receivables. If loans, CapCall's advances entitled it to a security, rather than an ownership, interest in the receivables junior to several other interests. As also stated, the court must resolve this threshold question before addressing whether certain transfers to CapCall were preferences and whether CapCall violated Montana usury law. If CapCall's advanced funds purchased property, any subsequent transfer of that property to CapCall would not be a preference. Likewise, if there was no loan, CapCall could not have violated usury laws. The court now turns to this question.

I. Applicable Substantive Law

Absent a contrary rule in the Bankruptcy Code, the contours of claims and property rights in bankruptcy cases are sculpted by applicable nonbankruptcy ***812** law. [33] Neither the Bankruptcy Code nor any other federal statute prescribes how to differentiate true sales from loans, which means bankruptcy courts must turn to state law. [34]

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Of course, the parties disagree about which state's law the court should apply to classify the transactions; CapCall maintains that New York law applies while the Trustee urges application of Montana law. This appears to tee up a potential choice-of-law issue. But the outcome of the true-sale-or-loan dispute remains the same regardless which state's law applies. The court therefore is constrained by the principle that a "choice-of-law determination is necessary only when a difference in the law will result in a different outcome."[35] Thus, the court need not make such a generalized determination at this step (though we will revisit the question later in connection with the usury claim).

II. Differentiating True Sales from Loans

An entity seeking liquidity may monetize its present or future accounts receivable in two primary ways: by either selling or borrowing against the receivables.[36] While the monetization methods differ in obvious and key respects, they are not entirely dissimilar. The shared aspects are reflected in the commentary to Article 9 of the Uniform Commercial Code where the drafters recognize that "[i]n many ***813** commercial financing transactions the distinction is blurred."[37] In light of this, Article 9 treats both secured loans and "a sale of accounts, chattel paper, payment intangibles, or promissory notes" as secured transactions subject to that statute's detailed rules regarding perfection and priority.[38] The statute stops short of "delineat[ing] how a particular transaction is to be classified" and, by design, the "issue is left to the courts."[39]

Courts have formulated a holistic, multipart framework to examine a transaction on the way to classifying it as a sale or a loan. In a notable article, Robert D. Aicher and William J. Fellerhoff catalog factors courts often consider:

(1) whether the buyer has a right of recourse against the seller;

(2) whether the seller continues to service the accounts and commingles receipts with its operating funds;

(3) whether there was an independent investigation by the buyer of the account debtor;

(4) whether the seller has a right to excess collections;

(5) whether the seller retains an option to repurchase accounts;

(6) whether the buyer can unilaterally alter the pricing terms;

(7) whether the seller has the absolute power to alter or compromise the terms of the underlying asset; and

(8) the language of the agreement and the conduct of the parties.[40]

As with many multi-factor tests, no individual factor or combination thereof is determinative.[41] The inquiry is not a quantitative exercise susceptible to replication by a computer program, but a comprehensive and heavily contextual endeavor. A court's "[a]nalysis of the various factors and their impact on the nature of the parties' agreement is fact-intensive, and a determination must be made based on the totality of the circumstances."[42] That said, a consideration that overlays and unites the factors is how the parties allocated ***risk***.[43] A sale ***814** typically occurs when the risk of loss from the purchased assets passes to the buyer – a gamble usually reflected in the purchase price. Conversely, in a disguised loan, the parties may employ various methods to allocate risk – the putative seller typically remains exposed to the underlying receivables and may grant the putative buyer recourse to sources of recovery beyond the receivables.

To elaborate on a point touched earlier, the court perceives no material difference in particular states' laws regarding the distinction between sales and loans. Nor do the parties clearly frame one (both have cited case law from assorted jurisdictions). Courts applying New York law look to the same sorts of factors, including those described in the Aicher and Fellerhoff article, as courts applying other states' law.[44] Moreover, New York courts have long approached this sort of problem by examining "the substance of the transaction between the parties" and identifying "the essential character of the transaction."[45] In New York, a "transaction must be judged by its real character, rather than by the form and color which the parties have seen fit to give it."[46] Montana, too, is a jurisdiction where "[t]he law looks to the substance rather than the form."[47] Thus, the court will apply those factors from the Aicher and Fellerhoff article and look to the overall transactional substance rather than attempt to formulate a material discrepancy between New York and Montana law on the matter.

III. Application of the Law to the Facts

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Applying the standards discussed above to the totality of the record established at trial, the court determines that the transactions at issue are loans. The following findings and conclusions support this determination.

First, the security interests reflected in the transaction documents are significantly broader than those associated with a sale and much more akin to those associated with a loan. For instance, a January 22, 2015 Merchant Agreement purports to secure the Shoot the Moon entity's "payment and performance obligations to" CapCall ***815** with "a security interest in all ... payment and general intangibles (including but not limited to tax refunds, registered and unregistered patents, trademarks, service marks, copyrights, trade names, trade secrets, customer lists, licenses, [etc.]); goods; inventory; equipment and fixtures ..., and all proceeds of the foregoing."[48] While this represents only a single example, other agreements contain substantially similar language conferring security interests overly generous for a sale. Consistent with these broad granting clauses, CapCall's UCC-1 financing statements usually describe the collateral as "[a]ll assets of the ***Debtor***, now existing and hereafter arising, wherever located" (emphasis added).[49]

The filing of a financing statement by itself is not indicative of a loan,[50] but the content of CapCall's statements is. Outside the context of a secured loan, there is no reason why CapCall should receive and perfect security interests in assorted assets other than the purchased receivables. Yet, as shown above, the typical Merchant Agreement and financing statement awarded CapCall a liberal security interest in the Shoot the Moon entity's assets. The restaurants' inventory, equipment, service marks, and other assets swept into the security agreements have little relation to the accounts that CapCall purportedly purchased.[51] The fact that the documents contemplate a broad security package for CapCall to generally collateralize payment obligations is indicative of a loan, not a sale.

To address CapCall's motive for filing UCC-1 financing statements, Mr. Marmott testified that merchant cash advance parties file UCC-1 financing statements as a matter of industry practice. This is undoubtedly true as far as it goes for the reasons already discussed. But Mr. Marmott's testimony did not rebut – nor did any other evidence – that collateral packages and financing statements of the exceptionally broad scope seen here are well beyond those associated with sales.[52] ***816** This evidence alone weighs powerfully in favor of classifying the transactions as loans. Mr. Marmott no doubt recognized this. At trial, he chose to outright deny CapCall's security interests in anything but the receivables despite being shown the broad scope of the granting clause explicit in the Merchant Agreements.

CapCall's financing statements contain another revealing indicator that they relate to secured loans: they identify each applicable Shoot the Moon entity as a "debtor." This is telling because CapCall could have easily referred to each as a "seller" or words of similar import if CapCall deemed such designation more accurate.[53]

Second, the transaction documents give CapCall rights and recourse against property in addition to the overbroad collateral package. To provide a common example, a March 16, 2015 Merchant Agreement and related documents provide the following:

- A broad personal guaranty by Shoot the Moon's principal that "is an absolute, primary, and continuing guaranty of ***payment and performance***" (emphasis added), "is a guaranty of payment and not merely a guaranty of collection," renders the guarantor "primarily liable, jointly and severally," with the Shoot the Moon entity, and includes various waivers such as of any requirement that CapCall "take any action ... against any security or collateral" before demanding payment from the guarantor.[54]
- An affidavit of confession of judgment whereby both the Shoot the Moon entity and the personal guarantor confess to a generalized judgment in a fixed sum equal to the total amount to be paid to CapCall plus legal fees and "interest at the rate of 16% per annum." The "judgment is for a debt due to [CapCall] arising from Defendants' failure to pay to [CapCall], [the Shoot the Moon entity's] accounts-receivable ... and for Defendants' breach of the secured Merchant Agreement" more generally.[55]
- Various "Protections Against Default" and other extraordinary rights, including provisions creating a broad power of attorney for CapCall, generally accelerating "[t]he full uncollected Purchased Amount," allowing CapCall to "enforce its security interest in the Collateral identified herein" (recall that this "Collateral" is far broader than just the putative purchased receivables), permitting CapCall to generally enforce "its rights and remedies by lawsuit," authorizing

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CapCall to exercise rights under an assignment of lease ***817** of the Shoot the Moon entity's premises (it is unclear how this would work in practice, but in theory it allows CapCall to take over the Shoot the Moon restaurants), and enabling CapCall to debit any of the Shoot the Moon entity's deposit accounts. [56]

- A continuing requirement that the Shoot the Moon entity provide CapCall with financial statements within five business days of CapCall's request; "failure to do so is a material breach of this Agreement." [57]

Although none of these features is dispositive alone, their collective effect weighs heavily in favor of characterizing the transactions as loans. As a whole, they provide CapCall with at least conditional recourse and expanded legal rights against the Shoot the Moon entities and the personal guarantors. Plus, they allocate great risk to the Shoot the Moon counterparty while protecting CapCall with much more than just the receivables. CapCall's panoply of rights, remedies, and potential control is highly unusual in the context of an asset sale. Such an overall arrangement is consistent with a debtor-creditor relationship, not a seller-buyer relationship.

This certainly did not escape Mr. Marmott. In familiar fashion, he tried to extinguish the extensive rights created for CapCall by simply denying that CapCall ever enforced them. These efforts are unavailing. As a foundational matter, Mr. Marmott's generous, and unilateral, waiver of CapCall's remedies is meaningless. Mr. Hatzenbeller testified that he was not made aware of any such waiver. What's more, the Merchant Agreements contain typical integration provisions stating that they embody the entire agreement. [58] So, Mr. Hatezenbeller could not rely on an undisclosed waiver much less one that conflicts with the agreements' terms. More significantly, it is immaterial whether CapCall exercised its rights. Many contracts crafted in myriad contexts – such as credit agreements, bond indentures, M&A agreements, intercreditor agreements, commercial leases, insurance contracts, and bankruptcy plans – have detailed (if not mind-numbing) provisions specifying the contracting parties' rights, remedies, and options in various scenarios. Most will never come to pass; others may, but a party might elect not to enforce or to forgo some or all of its rights (either formally, as in a forbearance agreement, or informally, such as by simple inaction). Refraining from enforcement does not render forgone rights void ab initio or strip them from a contract. In fact, the Merchant Agreements explicitly preserved for CapCall any rights it declined to enforce. [59] CapCall drafted the agreements and, in doing so, extended itself significant protections. CapCall cannot now simply disclaim those features to reframe the transactions as sales.

Third, the parties' course of performance also reflects a debtor-creditor relationship. The evidence at trial demonstrated that:

818** • The business actors often discussed the transactions in vernacular reserved for debtor-creditor relationships, such as "loans" with "terms" and "balances." Contemporaneous emails between Mr. Leak and Mr. Hatzenbeller are replete with references to and discussions of the parties' "loans" and economic arrangements (such as balances and terms) consistent with loans. [60] And recall from an earlier discussion that CapCall's financing statements labelled the Shoot the Moon entities as "debtors***." This jargon reflected the parties' subjective understanding of their transactions. Indeed, Mr. Hatzenbeller specifically testified that he conceptualized the transactions as "notes" akin to the promissory notes he signed when obtaining a traditional bank loan.

- Mr. Hatzenbeller funded many payments to CapCall through the deposit account of an entity having no operations or relationship to CapCall. The account commingled receivables CapCall purportedly bought with other funds, including those used to operate the restaurants. Mr. Leak, acting on CapCall's behalf, knew about the commingling, expressed no objection, and encouraged Mr. Hatzenbeller to structure the flow of funds however he preferred. Mr. Hatzenbeller testified that CapCall wanted only payment and communicated no interest in the source.

- The parties "stacked" or "rolled" funds from one transaction to the next. This practice committed a portion of the proceeds from a later transaction to satisfy the outstanding obligations of earlier transactions, effectively refinancing the earlier transactions. [61] This makes sense only ***819** in the context of a loan. Although theoretically possible, the transaction steps in the sale context would require the Shoot the Moon entities to rebuy future receivables previously sold to CapCall only to turn around and immediately resell the same receivables, and others, back to CapCall. Such circuitous behavior is nonsensical.

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This evidence reveals a course of dealing deeply inconsistent with true sales of receivables. CapCall presented no countervailing evidence to the contrary. As such, the court concludes that the parties' actions show that they intended to transact via loans.

Specifically applying the Aicher and Fellerhoff factors to the discussion above, the court notes that three weigh heavily in favor of classifying the transactions as loans. [62] First, as contemplated in the first factor, CapCall retained a definite right of recourse against the Shoot the Moon entities and several other parties. Second, as the second factor contemplates, the Shoot the Moon entities commingled funds from the accounts receivable with other funds and specifically those used to operate the restaurants, with CapCall's approval to boot. Finally, as contemplated by the eighth factor, the language contained in the agreements and the conduct of the parties reveal an apparent debtor-creditor, rather than seller-buyer, relationship. Considered in conjunction with the overall economic substance and risk allocation that connects the factors, the court concludes that the transactions are substantially similar to a loan.

While so concluding, the court acknowledges that the evidence is not entirely one-sided. The Merchant Agreements include lengthy provisions regarding how the central transaction "is not intended to be, nor shall it be construed as a loan" but instead is a purchase of receipts for an amount that "equals the fair market value of such [r]eceipts." [63] But this *ipse dixit* is hardly convincing; "[s]imply calling transactions 'sales' does not make them so" because "[l]abels cannot change the true nature of the underlying transactions." [64] In this case, the countervailing evidence reveals that the term "sale" in the agreements is nothing more than a conclusory and self-serving label. Perhaps a little more favorable to CapCall is case law in which courts found somewhat similar agreements to be sale transactions based on the inclusion of reconciliation provisions and the absence of fixed terms. [65] Here, at least some agreements ***820** include reconciliation provisions and none specify a fixed term. These aspects, however, do not outweigh the overwhelming other loan-like aspects of the transactions or the parties' dealings (including the express negotiation of de facto "terms" for some transactions). Finally, a few of the Aicher and Fellerhoff factors support CapCall's position to some extent. These include the absence of any provisions allowing the Shoot the Moon entities to repurchase the receivables as contemplated in factor five or permitting CapCall to alter the pricing terms as contemplated in factor six. It would be the rare case, though, when every factor points in the same direction. The applicable legal test requires a holistic approach keyed to specific facts and a weighing of factors. Here, the court has taken this approach and, after fully considering all the evidentiary support in CapCall's favor, concludes that it is comparatively insignificant and insufficient to overcome the determination the court reached above.

Montana Usury Claim

Now that the transactions are properly classified, the court can proceed to the Trustee's claim that the economic terms of certain loans expose CapCall to a usury penalty under Montana law. The Trustee limits this claim to the eleven transactions involving a Shoot the Moon LLC formed under Montana law. CapCall, in opposition, addresses little of the substance but strongly disputes that Montana law applies and urges application of New York law. 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. As such, the court must resolve the choice-of-law question.

I. Choice of Law Analysis

In federal cases predicated on bankruptcy jurisdiction, courts in the Ninth Circuit apply the "federal" choice-of-law rules based on the Restatement (Second) of Conflict of Laws. [66]

Restatement section 187(2) sets forth a general rule for disputes involving contracts with two exceptions:

> The law of the state chosen by the parties to govern their contractual rights and duties will be applied, even if the particular issue is one which the parties could not have resolved by an explicit provision in their agreement directed to that issue, unless either
>
> (a) the chosen state has no substantial relationship to the parties or the ***821** transaction and there is no other reasonable basis for the parties choice, or
>
> (b) application of the law of the chosen state would be [1] contrary to a fundamental policy of a state which [2] has a materially greater interest than the chosen state in the determination of the particular issue and [3] which, under the rule of § 188, would be the state of the applicable law in the absence of an effective choice of law by the parties. [67]

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The Restatement commentary explains that contract law generally operates "to protect the justified expectations of the parties and to make it possible for them to foretell with accuracy what will be their rights and liabilities under the contract," but this predictability value is overcome when a fundamental policy of a state that would otherwise provide the applicable law is in play since judicial "regard must also be had for state interests and for state regulation." [68]

Before applying this framework, the court must consider the scope of its application. Broadly, CapCall urges the court to construe the arrangements as part of a single larger agreement rather than several discrete agreements. Based on this construction, CapCall recasts its relationship with the Shoot the Moon entities as one involving a "multistate transaction" since CapCall also transacted with entities formed and operating in Idaho and Washington. CapCall insists that this construction is most faithful to the predictability rules endorsed by the Restatement. [69] CapCall's position is flawed.

CapCall's argument is predicated on an inaccurate characterization of the arrangements – there was not one multistate transaction ***among*** all parties, but a series of eighteen separately documented, standalone transactions ***between*** CapCall and each applicable Shoot the Moon entity. [70] CapCall asserts that the court can disregard the separateness of the eighteen transactions for two reasons. First, CapCall suggests the Shoot the Moon entities should not be treated as distinct legal persons. The record, however, provides no evidence to justify disregarding the foundational boundaries separating entities. Although Mr. Hatzenbeller used a consolidated account to move money throughout the enterprise, he documented the flow of funds as intercompany loans. Further, there is no evidence of hopeless entanglement among the entities or of any creditor confusion. [71] Second, CapCall argues that ***822** the individual transactions should be collapsed into a single integrated deal. Again, the record does not support this theory. Although there is some loose relationship among the transactions (particularly those refinancing others), the documents clearly set forth discrete, self-contained transactions with integration clauses that cut against the consideration of external factors as CapCall proposes. [72] Any evidence suggesting stronger linkage lacks clarity and weight. [73] Unfortunately for CapCall's current litigation position, it chose not to structure these transactions as part of a single, larger agreement. [74] The court declines CapCall's invitation to construe the agreements in such a manner now and applies the Restatement's framework on a contract-by-contract basis.

The eleven agreements at issue all provide that New York law applies. [75] Thus, this provision controls unless a Restatement section 187(2) exception applies. [76] The first, under paragraph (a), does not. CapCall is based and operates in New York, which creates the necessary relationship and some reasonable basis for the choice-of-law clause. If Montana law is to apply, then, all three conjunctive factors found in paragraph (b) must favor application of that state's law. The court concludes that each factor supports application of Montana law based on the following analysis.

Factor one: Applying New York law is inimical to the fundamental policy animating Montana's usury law. A "fundamental" policy is one reflected by a substantive rule, rather than a mere legal formality, such as "in a statute which makes one or more kinds of contracts illegal or which is designed to protect a person against the oppressive use of superior ***823** bargaining power." [77] This is the very policy and purpose of Montana's usury statute. As the Montana Supreme Court highlighted, "[u]sury statutes protect borrowers who lack real bargaining power against overreaching by creditors" and advance an important "public policy in favor of protecting the debtor." [78] And, as mentioned, New York lacks an analogous statute. Thus, applying that state's law would circumvent Montana's protections entirely. As such, the first factor is satisfied. [79]

Factor two: Montana has a materially greater interest in the determination of this particular issue than does New York. The borrowers in these transactions were legal entities formed under and governed by Montana law, owned by individual Montana citizens, and operated by an individual Montana citizen working from a Montana office. The only relevant link to New York is CapCall's place of business. This superficial connection generates little to no stake for New York in the outcome here. By contrast, among Montana's significant interests in regulating lending transactions involving its citizens is the harm to borrowers and collateral damage to other Montanans and the local economy when problematic transactions break bad. The underlying bankruptcy case here illustrates these interests well. As the evidence shows, the extremely high cost of the CapCall loans contributed to the Shoot the Moon entities' downward spiral. In turn, the failure of the businesses resulted in, among other things, financial losses for numerous Montana citizens. [80] As between the

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two states, Montana has a substantially greater interest in preventing lenders from circumventing its usury laws in transactions involving Montana borrowers. [81] Because of this materially greater interest, the second factor is satisfied.

Factor three: Under Restatement section 188, Montana law would control in the absence of an effective choice of law. Section 188(1) generally provides that "[t]he rights and duties of the parties with respect ***824** to an issue in contract are determined by the local law of the state which, with respect to that issue, has the most significant relationship to the transaction and the parties under the" overarching choice-of-law principles in Restatement section 6. [82] When applying those overarching principles, Restatement section 188(2) illustrates relevant contacts for consideration: "(a) the place of contracting, (b) the place of negotiation of the contract, (c) the place of performance, (d) the location of the subject matter of the contract, and (e) the domicile, residence, nationality, place of incorporation and place of business of the parties." [83] The "contacts are to be evaluated according to their relative importance with respect to the particular issue." [84] The commentary further instructs that "the interest of a state in having its contract rule applied in the determination of a particular issue will depend upon the purpose sought to be achieved by that rule and upon the relation of the state to the transaction and the parties." [85] Finally, the section 188(2) "factors are not to be applied mechanistically but qualitatively (based on the nature of the contract) in deciding which state has the most significant relationship to the parties and the contract." [86]

A holistic and qualitative evaluation of the relevant contacts in this proceeding demonstrates that Montana has the most significant relationship to the transactions and parties. Specifically:

- Though negotiations occurred via telephone and internet, the signatures necessary to make the documents binding always physically occurred in Montana. [87] No corresponding act occurred in New York.

- Montana was also the hub of performance. CapCall processed the agreed upon funding to fulfill its role while the Shoot the Moon entities fulfilled their primary role by repaying the "Specified Daily Amount." As Mr. Leak encouraged as CapCall's representative, both sides channeled the monetary performance through a Montana entity (Shoot the Moon Grizzly) using its account at a Montana bank (Prairie Mountain Bank). [88] Other than repayment, the agreements required the Shoot the Moon entities to comply with various negative covenants and other restrictions. These restrictions constrained how Mr. Hatzenbeller could operate the restaurants located in Montana from his Great Falls office.

- The subject matter of the agreements is also largely concentrated in Montana. The cash advances were intended to fund Montana entities, operating restaurants in Montana, managed solely by a Montana resident, from an office located in Montana, and utilizing accounts at a Montana bank. The ineluctable connection ***825** to Montana is evident on the face of each Merchant Agreement CapCall prepared as well as the UCC-1 financing statements CapCall filed with the Montana Secretary of State. [89]

- Finally, aside from CapCall, all players domiciled, resided, incorporated, and operated in Montana. CapCall is a Delaware LLC with a principal place of business in New York. The relevant Shoot the Moon entities all organized and conducted business in Montana – the same locale where Mr. Hatzenbeller resided and operated the businesses. Likewise, the personal guarantors and signatories of confessions of judgment all resided in Montana.

Montana's contacts permeate every aspect of the relevant agreements while any contacts attributable elsewhere, including New York, are de minimis. As such, the court concludes that Montana has, by a wide margin, the most significant relationship to the transactions and parties as contemplated by Restatement section 188(1). This conclusion satisfies the third factor of section 187(2)(b). Since all three criteria are satisfied, Montana law applies to the Trustee's claim concerning the eleven agreements with Montana entities. [90]

II. Application of Montana Law

Montana enacted statutes limiting the interest lenders (other than "regulated lenders") may charge. [91] Accordingly, contracting "[p]arties may agree in writing to the payment of any rate of interest that does not exceed the greater of 15% or an amount that is 6 percentage points per year above the prime rate published by the federal reserve system in its statistical release H.15 Selected Interest Rates for bank prime loans dated 3 business days prior to the execution of the

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agreement."[92] Here, there appears to be no dispute that the greater of the two amounts is 15%.

When a lender has taken, received, reserved, or charged interest greater than legally permitted, the statutory penalty is "forfeiture of a sum double the amount of interest" charged and an express remedy for the borrower or its successor to recover "a sum double the amount of interest paid."[93] The lender "need not know that the particular interest rate is usurious and illegal" but merely needs to consummate a transaction charging an interest rate that is usurious in ***826** fact.[94] "[B]efore any suit may be brought to recover the usurious interest, the party bringing suit" must make "written demand for return of the interest paid."[95]

The Trustee made the required written demand in relation to the eleven loans here.[96] The Trustee's expert witness, Ms. Manos, performed a detailed analysis of the relevant transactions to calculate (i) the effective rate of interest CapCall charged and (ii) the applicable usury penalty under Montana law.[97] CapCall did not challenge the details of the calculations or introduce evidence or analysis supporting alternative amounts. Based on the lack of objection, Ms. Manos' credibility, and an independent review of her analysis, the court finds that the calculations appropriately quantify the interest rates applicable to the specified transactions and the resulting penalty.[98] Additionally, based on the parties' relative sophistication and the overall context of the transactions, specifically CapCall's vast experience transacting with merchants and its exclusive control over the legal documentation, the court concludes that there is no equitable consideration weighing against enforcing the full penalty.[99] To the contrary, straightforward application of Montana law advances the statutory purpose of "protect[ing] borrowers who lack real bargaining power against overreaching by creditors."[100] Thus, the court imposes the statutory penalty in its entirety.

III. Judgment

Based on the above analysis, the Trustee is entitled to judgment on his usury claim against CapCall in the amount of $1,216,685.

Preference Claim

According to the Trustee's second claim, CapCall received funds within the 90 days immediately preceding the petition date on account of its loans to the Shoot the Moon entities. The Trustee asserts these transfers are avoidable and recoverable pursuant to Bankruptcy Code sections 547 and 550. Preference actions under the Bankruptcy Code are intended to deter the proverbial "race to courthouse" or other collection activity against an insolvent debtor and to further the prime bankruptcy policy of equality of distribution among ***827** similarly situated creditors.[101] Indeed, the authority "to avoid preferential transfers and to recover the transferred property ... has been a core aspect of the administration of bankrupt estates since at least the 18th century."[102]

I. Statutory Preference Elements

To prevail on his preference claim, the Trustee has the burden of proving, by a preponderance of the evidence,[103] the following seven elements:[104]

(1) a transfer

(2) of the debtor's property

(3) to or for the benefit of a creditor

(4) for or on account of an antecedent debt

(5) made while the debtor was insolvent

(6) within 90 days of the filing of the petition in bankruptcy

(7) that enables the creditor to receive more than he would under a Chapter 7 liquidation.[105]

Based on the totality of the record established at trial, the court determines that the Trustee has sustained this burden and, therefore, is entitled to avoid and recover the challenged transfers from CapCall, subject to one caveat discussed below. Following the elements above in turn, the record demonstrates that:

First, transfers in the aggregate of $1,129,071.00 were made to or for the benefit of CapCall.[106] CapCall has offered no evidence or allegation otherwise.

Second, the $1,129,071 transferred was the debtor's property. While CapCall does not dispute that the funds belonged to the various Shoot the Moon entities upon transfer, it does dispute that these funds belonged to the debtor. The argument is that the several entities merged on the eve of bankruptcy to form a single entity that became the debtor, hence the funds

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could not have belonged to the "debtor" because it did not exist at the relevant date. Bankruptcy Judge Terry L. Myers rejected an identical argument made in one of the several related adversary proceedings.[107] The court agrees with and adopts Judge Myers' analysis regarding the issue.[108] The rationale is consistent ***828** with precedent giving a broad construction to the scope of property in the bankruptcy context.[109] Moreover, " 'property of the debtor' subject to the preferential transfer provision is best understood as that property that would have been part of the estate had it not been transferred before the commencement of bankruptcy proceedings."[110] In short, if the funds were not transferred to CapCall, they would have remained property of the Shoot the Moon entities before the merger, then property of the merged entity, and finally property of the estate. These transfers ultimately diminished the Shoot the Moon bankruptcy estate, which means they were transfers of the debtor's property for purposes of Bankruptcy Code section 547.[111]

Third, the $1,129,071 in transfers were to or for the benefit of CapCall in its capacity as a "creditor."[112]

Fourth, the transferred funds were used to satisfy the prepetition loan obligations already discussed. Thus, the transfers were for or on account of an antecedent debt.[113]

Fifth, the transfers were made while the Shoot the Moon entities were insolvent. As an initial matter, the Trustee enjoys a presumption of insolvency[114] and CapCall introduced no evidence or argument to rebut the presumption. Aside from this, the Trustee presented evidence of insolvency. Ms. Manos testified that the entities were insolvent, both individually ***829** and collectively, and she offered documents showing the work she used to arrive at this conclusion.[115] Mr. Hatzenbeller also testified that the Shoot the Moon enterprise had effectively become trapped in a death spiral by no later than the summer of 2015.

Sixth, all the challenged transfers were made within 90 days of the petition date. The bankruptcy case was filed on October 21, 2015, and Ms. Manos' calculations are specifically limited to payments within the previous 90 days.[116]

Seventh, the transfers enabled CapCall to receive more than it would have in a chapter 7 liquidation. This final inquiry is "sometimes referred to as the 'greater amount' test [and] requires the court to construct a hypothetical chapter 7 case and determine what the creditor would have received if the case had proceeded under chapter 7."[117] In this case, the scenario is something less than hypothetical because the Trustee actually liquidated most of the bankruptcy estate property in the same manner a hypothetical chapter 7 trustee would proceed. Nevertheless, the court will embark on the complete exercise.

In a hypothetical chapter 7 case, the funds transferred to CapCall would have instead become property of the chapter 7 estate subject to the security interests of CapCall that are junior to other security interests in the same assets. A chapter 7 trustee might seek to use this cash collateral to operate the restaurants for a limited period to preserve assets.[118] The chapter 7 trustee then would try to do what the Trustee actually did here – reduce the business assets to cash via a section 363 sale.[119] The hypothetical sale could not have obtained a greater net purchase price than the Trustee's actual sale and likely would have obtained less. The chapter 7 trustee thus would be left with, at best, the same sale proceeds and the cash that counterfactually was not transferred to CapCall. As with the present case, this amount would be insufficient to satisfy secured claims senior to CapCall.[120] CapCall therefore would have only a general unsecured claim,[121] which would generate a limited, if any, distribution from the chapter 7 estate. As Ms. Manos testified at trial, then, the prepetition transfers to CapCall enabled CapCall to recover significantly more than CapCall would have received in a hypothetical chapter 7 liquidation and the "greater amount" test is satisfied.[122]

In its post-trial submission, CapCall offers the following arguments regarding the "greater amount" test:

> CapCall's claims in a hypothetical Chapter 7 would have resulted in an enforceable lien both at the time of filing said petition for Chapter 7 protection as well as during the pendency of the case administration. ***830** Specifically, CapCall would have had a lien on the debtor's accounts at the time of filing. The extent to which there were other creditors that similarly had liens does not affect the extent to which the

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> lien would be legally enforceable. Further, the primary asset secured by CapCall's lien would be not just the accounts of the debtor but the *future* receivables as well and their proceeds as liquidated. [123]

These points ignore fundamentals of the Bankruptcy Code. The "extent to which there were other creditors that similarly had liens" on the same collateral certainly ***does*** "affect the extent to which the lien would be legally enforceable" under Bankruptcy Code section 506. This section limits a secured claim "to the extent of the value of such creditor's interest in the estate's interest in such property" and bifurcates the remainder as "an unsecured claim to the extent that the value of such creditor's interest ... is less than the amount of such allowed claim." [124] Thus, if liens senior to CapCall's exceed the value of the collateral, then CapCall is left with an unsecured claim (because the value of its junior, out-of-the-money interest is $0) and no enforceable lien. [125] Further, CapCall's security interest regarding future receivables not existing on the petition date terminates under Bankruptcy Code section 552 insofar as those future receivables are "property acquired by the estate or by the debtor after the commencement of the case" but not "proceeds, products, offspring, or profits" of property in which CapCall had a security interest and which was extant on the petition date. [126] And, even absent section 552, CapCall's lien would still be junior to senior, but undersecured, lienholders and CapCall would be back where it started: with an unsecured claim and an unenforceable lien. Despite CapCall's efforts, it cannot spoil the Bankruptcy Code fruits growing from the seed of senior-yet-undersecured liens on the collateral granted to secure the Shoot the Moon entities' obligations to CapCall. [127]

II. Recovery Limitations

Although the Trustee prevails on the preference claim under Bankruptcy Code section 547(b), he is "entitled to only a single satisfaction" in an avoidance action. [128] Consistent with this mandate, the court should eliminate any overlap between recovery on the claim here and recovery on the usury claim above. [129] Some ***831** preferential transfers include interest CapCall must return because of the judgment on the usury claim. The Trustee could obtain more than a single recovery if CapCall is required to return the same money to satisfy each judgment separately. Therefore, the Trustee is entitled to a judgment in the full amount of the preferential transfers subject to a reduction on a dollar-for-dollar basis equal to any imputed interest included within the preferential payments, but only to the extent CapCall actually satisfies in full its liability to the Trustee under the Montana usury statute.

III. Judgment

Subject to the judgment-reduction provision above, the Trustee is entitled to avoidance and recovery of preferential transfers totaling $1,129,071.

Other Issues

The parties raise a handful of other claims and issues requiring attention.

I. CapCall's Claims

After the petition date, credit card payments continued to be processed from business operations. CapCall asserts ownership of the funds based on its purported purchase of the receivables. The Trustee received and utilized a portion of those funds, and the balance is held in the segregated account mentioned previously. CapCall seeks (i) a monetary judgment against the Trustee for conversion of the portion of the funds the Trustee received and (ii) a declaratory judgment that the remaining balance held in the segregated account belongs to CapCall. The court effectively disposed of these claims upon determining that CapCall did not purchase the receivables but extended loans collateralized by the assets – loans that are ultimately unsecured for the reasons described above. [130] Because CapCall lacks an ownership or enforceable security interest in the receivables, these claims are nonstarters and the Trustee is entitled to the ***832** remaining segregated account. [131]

II. CapCall's General Unsecured Claim: Allowance & Subordination

Because CapCall is obligated to the bankruptcy estate on the preference claim, CapCall is not entitled to payment on its proof of claim until it has satisfied the judgment set forth herein. [132] Thus, CapCall's claim is presently disallowed. CapCall may file an amended proof of claim, within 30 days after satisfying the judgment related to the preference claim, detailing any additional amounts that CapCall asserts under Bankruptcy Code section 502(h). The Trustee must object within 60 days or CapCall's amended proof of claim will

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constitute CapCall's allowed general unsecured claim for all purposes in the bankruptcy case. [133]

III. Attorneys' Fees and Costs

The Trustee asserts a right to an award of attorneys' fees against CapCall pursuant to Montana's reciprocal fee statute, which makes unilateral fee provisions bilateral regarding "any action on the contract" and entitles the prevailing party in such an action "to recover reasonable attorney fees from the losing party." [134] The eleven agreements subject to ***833** Montana law each create an express right for CapCall to recover court costs and attorneys' fees associated with CapCall's enforcement of its broadly-defined rights and remedies. [135] Thus, the court must assess whether these proceedings involve an action "on the contract." [136]

i. This Litigation Arises From the Merchant Agreements

In answering such questions, Montana courts apply the concept broadly and award reciprocal fees in varied contexts even when a contract is successfully attacked. [137] This broad approach is consistent with decisions of the Ninth Circuit Court of Appeals applying similar reciprocal fee statutes of other states and concluding that actions are "on a contract" when the litigation generally "involves" that contract or a party's efforts "to enforce, or avoid enforcement of, the provisions of the contract." [138] That the litigation arises in a bankruptcy context, involves some bankruptcy issues, or perhaps is even largely premised on a dispute about the Bankruptcy Code's operation does not affect whether an action is on the contract. [139] Rather, the focus should be on the role and import of the contract in the litigation as well as whether the losing party "*could* have sought fees under the contract" had it prevailed. [140]

The court concludes that the following aspects of this adversary proceeding constitute an "action on the contract" for purposes of Montana's fee-shifting statute:

- **True sales vs. disguised loans, conversion, and segregated funds**. The parties' dispute regarding these matters stems entirely from CapCall's efforts to enforce provisions of the Merchant Agreements based on its interpretation of those agreements. As the court's extensive earlier discussion demonstrates, resolution of the dispute requires significant review and interpretation of numerous aspects of the agreements and related documents.

- **Choice-of-law and usury disputes**. The genesis of both issues is again the Merchant Agreements. To reach the usury claim, the court needed to resolve two threshold questions: first, whether the transactions amounted to loans or sales and, second, whether New York or Montana law applies. Again, these issues cannot ***834** be resolved without closely considering the substance of the Merchant Agreements. Once resolved, the next step required the court to examine the payment obligations under the agreements to determine the imputed interest rates for the transactions, as Ms. Manos did during her expert testimony.

- **Preference claim**. As Bankruptcy Judge Charles Novack explained in the context of California's similar reciprocal fee statute, "[a] preference action is premised on an 'antecedent debt' (i.e. a contractual obligation) and payments being made on that debt (which payments the Trustee sought to avoid)." [141] As in Judge Novack's case, resolution of the preference claim here required consideration of the Merchant Agreements and related documents and, of course, determination whether CapCall was a creditor or a purchaser.

The broad fee provisions in sections 3.2 and 3.3 of the agreements would entitle CapCall to attorneys' fees upon prevailing in the adversary proceeding. CapCall has in fact sought such fees. Therefore, CapCall recognizes that this litigation arises from the Merchant Agreements and triggers their fee provisions.

ii. Fee Award

An award of attorneys' fees under Montana Code section 28-3-704 must be "reasonable." The determination of a reasonable fee amount is committed to the trial court's discretion. [142] The Trustee argues that the court should key an award to the contingency-fee arrangement with his counsel and "award attorney's fees in the amount of 40% of the gross sum of any judgment entered in this matter." [143] When fixing the amount of a reasonable fee, the trial court may consider but "is not bound [by] a contingent fee agreement." [144] Rather, the overarching inquiry must incorporate the typical factors Montana courts use to determine a reasonable award. [145]

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Here, many factors support a substantial award for the Trustee. This litigation has been pending for four years and involved significant legal work, including discovery, several rounds of motion practice, a formal mediation and other settlement ***835** efforts, a multiday trial, and post-trial briefing and argument. The amount of money at stake is substantial and the issues are largely binary, which creates a material risk of no recovery for the Trustee's counsel. As this opinion evinces, the issues involved in this case are complicated and highly factual. [146] Moreover, the litigation has been hard-fought by competent lawyers zealously advocating for CapCall (including, at one point, lawyers with a national practice based in New York, as well as several experienced and reputable Montana lawyers). To the best of the court's knowledge, the Trustee counsel have a fine reputation for character and standing in the profession and the court has been impressed with the quality of their legal work, particularly the efficient and professional presentation of evidence and witness examination at trial. Finally, the results secured by counsel's service are significant – this adversary proceeding yields a multi-million-dollar judgment and potential recovery for the benefit of the bankruptcy estate – and there may be additional work the Trustee's counsel must do in connection with any appeals or to enforce the judgment.

All that said, the court deems it excessive to require CapCall to pay an additional 40% of the entire gross judgment. Some amounts reflect a penalty component (such as the usury claim). Awarding a full contingency fee based on these penalties is simply inflating the judgment. [147] Additionally, the nominal amount of the judgment to be entered regarding the preference claim will be reduced by a yet-to-be-determined amount if and when CapCall pays the full amount of the Montana usury penalty. And some of the preferential transfers related to Merchant Agreements that did not involve Montana parties. Thus, a downward adjustment is warranted.

After considering the totality of the circumstances and the specific factors courts utilize under Montana law, the court concludes that a reasonable fee under Montana Code section 28-3-704 is: **[a]** 30% of the balance of the segregated funds ($68,512.48), **[b]** 20% of the amount of the Montana usury penalty ($243,337), and **[c]** 10% of the amount of the avoided preferential transfers ($112,907.10), which results in a total fee award of $424,756.58. [148]

iii. Costs

The Trustee also seeks recovery of $2,159.75 in costs. The plain text of Montana Code section 28-3-704 does not mention costs and imposes a reciprocal obligation only regarding attorneys' fees. [149] The Trustee identifies no other basis for an award of costs and the court therefore denies the request.

SUMMATION

The Trustee is entitled to a judgment against CapCall consistent with this opinion. The Trustee should submit a proposed ***836** form of final judgment and indicate whether CapCall agrees to or contests the proposed form.

All Citations

635 B.R. 797, 70 Bankr.Ct.Dec. 187

Footnotes

1 This opinion sets forth the court's findings of fact and conclusions of law pursuant to Federal Rule of Bankruptcy Procedure 7052 and Federal Rule of Civil Procedure 52(a). If any findings of fact are more properly construed as conclusions of law, or vice versa, they are adopted and should be construed as such.

2 *See* Final Pretrial Order ¶¶ IV.1, 3-5, ECF No. 260.

3 *See, e.g.*, Trial Exs. 30-77.

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4 *See, e.g.*, Trial Exs. 147 (Prairie Mountain Bank filings with the Idaho and Montana Secretaries of State), 148 (American Express Bank filings with the Montana Secretary of State), 149 (US Foods filing with the Montana Secretary of State).

5 *See* Final Pretrial Order ¶ IV.6, ECF No. 260; Trial Exs. 19 (the date of the agreement listed as item no. 6 was orally corrected at trial as 4/6/15), 101-118, 204-211.

6 *See, e.g.*, Trial Ex. 144.

7 Trial Ex. 138. *See also, e.g.*, Trial Exs. 130, 133; Leak Dep. 38:14-41:9, ECF No. 268-1; Leak 30(b)(6) Dep. 38:2-39:19, ECF No. 268-2.

8 In his emails, Mr. Leak's signature block represented that he was a "Sr. Underwriting Manager" of CapCall, however, he worked as an independent contractor for CapCall rather than as an employee. *See, e.g.*, Trial Ex. 127. In letters printed on CapCall letterhead, Mr. Leak also called himself a "Managing Director" of CapCall. *See* Trial Exs. 140-141. Aspects of the email arrangements Mr. Leak used seem highly unusual. For example, on March 10, 2015, Mr. Hatzenbeller wrote Mr. Leak at his usual email address, but appears to have received a response from a "Josh Altman" from a different email address, followed five minutes later by a textually-identical response from Mr. Leak. *See* Trial Ex. 127. No explanation was provided at trial regarding who Mr. Altman is or why he was responding to emails sent to Mr. Leak.

9 *See, e.g.*, Trial Exs. 133, 136.

10 *See* Trial Exs. 127-129, 136, 139.

11 *See* Final Pretrial Order ¶ IV.8, ECF No. 260; Trial Exs. 180-192.

12 *See* Final Pretrial Order ¶ IV.9, ECF No. 260.

13 *See, e.g.*, Trial Ex. 155.

14 *See* Trial Ex. 152 (column for claims that were "Secured Converted to Unsecured after Sale Closure").

15 *See* Final Pretrial Order ¶ IV.10, ECF No. 260.

16 *See id.* ¶¶ IV.11-12; Trial Exs. 161-162.

17 *See* Final Pretrial Order ¶ IV.13, ECF No. 260; Trial Ex. 142.

18 *See* ECF Nos. 268, 271, 272.

19 *See* Trial Ex. 157.

20 *See* Trial Ex. 144; see also Trial Exs. 158-160 (compilations of the underlying bank statements).

21 *See* Trial Ex. 145.

22 *See also* Trial Ex. 129 (reflecting the arrangement of such a transaction).

23 *See also* Hatzenbeller Dep. 19:18-22:20, 34:14-23, ECF No. 271-1.

24 *See* 28 U.S.C. § 1409(a).

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25 *See, e.g.*, Preliminary Pretrial Order ¶ 2, ECF No. 26; Stipulated Sch. Order ¶ 4, ECF No. 53, Final Pretrial Order ¶ II, ECF No. 260 (bilateral order recites that the adversary proceeding is core).

26 *See* 28 U.S.C. § 157(b)(1), (c)(2); Wellness Int'l Network, Ltd. v. Sharif, 575 U.S. 665, 674-81, 135 S.Ct. 1932, 191 L.Ed.2d 911 (2015).

27 *See* Suppl. Post Trial Br. 8-12, ECF No. 275.

28 *See, e.g.*, *Spokeo, Inc. v. Robins*, 578 U.S. 330, 136 S. Ct. 1540, 1547, 194 L.Ed.2d 635 (2016); *Steel Co. v. Citizens for a Better Env't*, 523 U.S. 83, 94-97, 118 S.Ct. 1003, 140 L.Ed.2d 210 (1998).

29 *See, e.g.*, *Czyzewski v. Jevic Holding Corp.*, —— U.S. ——, 137 S. Ct. 973, 983, 197 L.Ed.2d 398 (2017).

30 CapCall's arguments regarding the Trustee's standing to pursue claims for declaratory relief are analytically odd. The usual problem courts address regarding attacks on claims asserted under the Declaratory Relief Act occurs when those claims are pursued as standalone claims (often seeking what amounts to an advisory opinion) without an independent basis for federal jurisdiction. *See, e.g.*, *Shell Gulf of Mex. Inc. v. Ctr. for Biological Diversity, Inc.*, 771 F.3d 632, 635 (9th Cir. 2014). Here, however, there is no dispute that the court has federal bankruptcy jurisdiction pursuant to 28 U.S.C. §§ 1334(b) & 157(a). *See, e.g.*, Final Pretrial Order ¶ II, ECF No. 260. Indeed, it was CapCall that commenced this adversary proceeding and first invoked this court's federal bankruptcy jurisdiction. *See* Compl., ECF No. 1 ¶ 1.

31 *See, e.g.*, *Seitz v. 6130 W., LLC (In re Joey's Steakhouse, LLC)*, 474 B.R. 167, 183-84 (Bankr. E.D. Pa. 2012) (concluding that request for declaratory relief was moot when the parties were "engaged in full-blown litigation" requiring adjudication of substantive issues that "will perforce determine the rights of each party").

32 To conclude otherwise would render strange results. Since state law largely dictates property rights in bankruptcy, a party's inability to press a dispute about an interest in property would render meaningless many statutory rights and powers conferred by the Bankruptcy Code. The rules of procedure recognize these rights and powers and specifically require "a proceeding to determine the validity, priority, or extent of a lien or other interest in property" to commence by adversary complaint. Fed. R. Bankr. P. 7001(2).

33 *See, e.g.*, *Midland Funding, LLC v. Johnson*, —— U.S. ——, 137 S. Ct. 1407, 1411-12, 197 L.Ed.2d 790 (2017); *Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Elec.*, 549 U.S. 443, 450-51, 127 S.Ct. 1199, 167 L.Ed.2d 178 (2007); *Butner v. United States*, 440 U.S. 48, 55-57, 99 S.Ct. 914, 59 L.Ed.2d 136 (1979); *Official Comm. of Unsecured Creditors v. Hancock Park Capital II, L.P. (In re Fitness Holdings Int'l, Inc.)*, 714 F.3d 1141, 1146-49 (9th Cir. 2013). This modern approach is in tension with older Supreme Court precedent, which reflects a tradition of allowing bankruptcy courts to determine transactional substance as a matter of generalized bankruptcy law. *See, e.g.*, *Pepper v. Litton*, 308 U.S. 295, 304-06, 60 S.Ct. 238, 84 L.Ed. 281 (1939) (Douglas, J.); *Sawyer v. Hoag*, 84 U.S. (17 Wall.) 610, 619-22, 21 L.Ed. 731 (1873). When the applicable state law adopts a searching, fact-specific, and holistic inquiry into the substance of the transaction, however, this often will be a distinction that makes little or no difference to the ultimate outcome. *See, e.g.*, *United Airlines, Inc. v. HSBC Bank USA, N.A.*, 416 F.3d 609, 613-15 (7th Cir. 2005).

34 *See, e.g.*, *In re R&J Pizza Corp*., 2014 Bankr. LEXIS 5461, at *5-6 (Bankr. E.D.N.Y. Oct. 14, 2014); *Paloian v. LaSalle Bank Nat'l Ass'n (In re Doctors Hosp. of Hyde Park, Inc.)*, 507 B.R. 558, 708 (Bankr. N.D. Ill. 2013); *In re Criimi Mae, Inc*., 251 B.R. 796, 801 (Bankr. D. Md. 2000).

35 *Villarreal v. Arnold*, 2016 WL 7374272, at *2, 2016 U.S. Dist. LEXIS 176103, at *5 (N.D. Ill. Dec. 20, 2016). *See also, e.g., Nguyen v. Barnes & Noble Inc.*, 763 F.3d 1171, 1175 (9th Cir. 2014) (explaining that a choice-of-law inquiry is not necessary when both options "dictate the same outcome"); *In re Aircrash Disaster Near Roselawn*, 948 F. Supp. 747, 750 (N.D. Ill. 1996) ("A court need not conduct a choice of law determination

unless there is an actual conflict in the substantive law such that the case could have a different outcome depending on which law is applied.").

36 The most straightforward sale transaction occurs when party A sells receivables to party B. A "securitization" is a more complex form of sale transaction whereby the seller transfers the receivables to a special purpose entity, which entity then issues to third parties debt securities collateralized by the receivables in exchange for capital that completes the purchase transaction. *See generally* Kenneth N. Klee & Brendt C. Butler, *Asset-Backed Securitization, Special Purpose Vehicles and Other Securitization Issues*, ALI-ABA Course of Study Materials SJ082 (June 2004). Securitizations are commonly used in the context of mortgage loans, student loans, and assorted other debt obligations.

37 U.C.C. § 9-109 Official Comment 4.

38 *See id*. § 9-109(a)(3). There are some specific exceptions to this general rule. *See id*. § 9-109(d)(4)-(7). There are also some Article 9 provisions providing rules specifically for sold rights to payment. See, e.g., id. §§ 9-309(3)-(4); 9-318.

39 *Id*. § 9-109 Official Comment 4. See also id. § 9-318 Official Comment 2 (similarly noting that "[n]either this article nor the definition of 'security interest' in section 1-201 provides rules for distinguishing sales transactions from those that create a security interest securing an obligation").

40 *See* Robert D. Aicher & William J. Fellerhoff, *Characterization of a Transfer of Receivables as a Sale or a Secured Loan Upon Bankruptcy of the Transferor*, 65 AM. BANKR. L.J. 181, 186-94 (1991). The Aicher and Fellerhoff article cites and collects various cases to support its inventory of the relevant factors. Other courts have since relied on this articulation of the relevant legal principles. *See, e.g.*, *Dryden Advisory Grp., LLC v. Beneficial Mut. Sav. Bank (In re Dryden Advisory Grp., LLC)*, 534 B.R. 612, 620 (Bankr. M.D. Pa. 2015); *In re R&J Pizza Corp.*, 2014 Bankr. LEXIS 5461, at *7-8 (Bankr. E.D.N.Y. Oct. 14, 2014); *Sterling Vision, Inc. v. Sterling Optical Corp. (In re Sterling Optical Corp.)*, 371 B.R. 680, 686-87 (Bankr. S.D.N.Y. 2007).

41 Official Comm. of Unsecured Creditors v. LG Funding, LLC (In re Cornerstone Tower Servs.), 2018 WL 6199131, at *5-6, 2018 Bankr. LEXIS 3562, at *13 (Bankr. D. Neb. Nov. 9, 2018).

42 *In re Dryden Advisory Grp.*, 534 B.R. at 620.

43 *See, e.g.*, *S & H Packing & Sales Co. v. Tanimura Distrib.*, 883 F.3d 797, 802 (9th Cir. 2018) (en banc) (holding, in the PACA trust context, that a "court should look to the substance of the transaction to determine whether the transaction is a true sale or a secured loan" and "[i]n doing so, the transfer of risk should be a primary factor to which a court looks"); *Endico Potatoes, Inc. v. CIT Group/Factoring, Inc.*, 67 F.3d 1063, 1069 (2d Cir. 1995) (explaining that "[t]he root of all of these factors is the transfer of risk"); *Major's Furniture Mart, Inc. v. Castle Credit Corp.*, 602 F.2d 538, 545-46 (3d Cir. 1979) (discussing various aspects of how a transaction allocated risk and concluding "that on this record none of the risks present in a true sale is present here"); *In re Dryden Advisory Grp.*, 534 B.R. at 620 ("To classify a transaction accurately, several attributes must be examined, primarily the allocation of risk."); *In re Cornerstone Tower Servs.*, 2018 WL 6199131, at *5-6, 2018 Bankr. LEXIS 3562, at *13 (emphasizing how, across the holistic analysis, "the allocation of risk is primary to the determination").

44 *See, e.g.*, *In re Dryden Advisory Grp.*, 534 B.R. at 620-26; *In re Cornerstone Tower Servs.*, 2018 WL 6199131, at *5-8, 2018 Bankr. LEXIS 3562, at *12-22.

45 *See, e.g.*, *Hall v. Eagle Ins.*, 151 A.D. 815, 822-26, 136 N.Y.S. 774 (N.Y. App. Div. 1912), aff'd, 211 N.Y. 507, 105 N.E. 1085 (1914).

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46 *Quackenbos v. Sayer*, 62 N.Y. 344, 346 (1875). *See also, e.g.*, *Fast Trak Inv. Co. v. Sax*, 962 F.3d 455, 467 (9th Cir. 2020) (noting how the court is "bound by New York law to analyze the transaction and determine its 'real character' ").

47 *Stanhope v. Shambow*, 54 Mont. 360, 363, 170 P. 752 (1918). *See also, e.g.*, Mont. Code Ann. § 1-3-219 ("The law respects form less than substance."); *In re Charles M. Bair Family Trust*, 343 Mont. 138, 148, 183 P.3d 61 (2008) (discussing how Montana courts "emphasize substance over form" when interpreting legal instruments).

48 Trial Ex. 102 at p. 2.

49 *See* Trial Exs. 204, 206, 208-211. One financing statement has a longer and more precise description of the collateral, but it too extends far beyond receivables by including, among other things, "general intangibles," "goods," "inventory equipment and fixtures," and "all computer programs." *See* Trial Ex. 205.

50 Recall that Article 9 of the UCC applies to sales of accounts. So, it is not surprising that CapCall filed financing statements to perfect its interest in the putative purchased accounts – a buyer of accounts who fails to perfect its interest in that property by filing a financing statement runs the risk of becoming subordinate to a subsequent buyer or other secured party who is perfected. *See* U.C.C. § 9-318 Official Comment 3 (example describing contest between Buyer-1 and Buyer-2).

51 To crystalize the point by analogy, someone agreeing to buy a house six months in the future may record an interest against the house in order to protect against intervening buyers or judgment creditors (or a bankruptcy trustee) but would not record any interest against the seller's car or personal property.

52 Even assuming CapCall introduced evidence of an on-point "industry practice" or "commercial expectation," it is questionable its relevance to resolving the dispute before the court. The court's task is to apply the law to the facts before it; policy arguments related to industry practices, asserted market expectations, or the like are properly left to the legislative branch. *See, e.g.*, *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 566 U.S. 639, 649, 132 S.Ct. 2065, 182 L.Ed.2d 967 (2012); *W. Pac. Airlines v. GATX Capital (In re W. Pac. Airlines)*, 221 B.R. 1, 6 (D. Colo. 1998); *Lehman Bros. Special Fin. Inc. v. BNY Corporate Tr. Servs. Ltd. (In re Lehman Bros. Holdings Inc.)*, 422 B.R. 407, 422 n.9 (Bankr. S.D.N.Y. 2010). That said, if what occurred in this case actually is the industry's practice in the context of transactions intended to be true sales of receivables, it is misguided and warrants reconsideration, including in light of the Uniform Commercial Code sections and commentary cited above.

53 *See* U.C.C. § 9-505(a).

54 Trial Ex. 105 at p. 2. Once again, the plain terms of the documents are inconsistent with Mr. Marmott's trial testimony. Mr. Marmott testified that all the guaranties were ***only*** of performance, not payment. The emphasized language quoted above says precisely the opposite. Indeed, more than half of the Merchant Agreements include language expressly creating an "absolute ... guaranty of payment" (i.e., trial exhibits 101-108, 110, 113). The other Merchant Agreements are somewhat more limited in the scope of the guaranty, but that is a distinction without a difference insofar as the personal guaranty of "performance" of an "obligation" to pay money to CapCall is functionally a payment guaranty, as the affidavits of confession of judgment imposing accelerated liquidated sums due by the guarantors demonstrate.

55 Trial Ex. 105 at pp. bates stamped Cap Call - 000052 through 000054.

56 *See* Trial Ex. 105 at pp. 3-5 §§ 1.10, 1.11, 3.1, 3.2. The agreements are not uniform in terms of the ramifications of a Shoot the Moon bankruptcy filing. Some simply provide that a bankruptcy filing will trigger the "protections" related to the confessions of judgment and personal guaranties. Others treat a bankruptcy

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filing as a broader event of default that could perhaps support broader remedies (or "claims" in the bankruptcy case). These Merchant Agreements are not models of precision or legal drafting.

57 *See id*. at p. 4 § 2.1.

58 *See id*. at p. 5 § 4.8.

59 *See id*. at p. 5 § 4.4.

60 *See* Trial Exs. 127 (email subject "Loan"), 128 (Hatzenbeller requesting list of "the notes I have with you and the amount left on them"), 129 (Hatzenbeller asking, "Which loan are we going to pay off?"; Leak responding with "the balance on that one"), 136 (email subject "Loans" and Hatzenbeller requesting summary of "all the loans I have with you and the amounts owing on each"; later messages about refinancing the "balance" owed on one of the "loans"), 139 (Hatzenbeller requesting a "statement for the out standing [sic] loans with you"; Hatzenbeller and Leak then negotiating for a "six month term").

61 In its post-trial submission CapCall asserts that there is insufficient evidence these "rolling" transactions actually occurred. *See* Suppl. Post Trial Br. 2-3, ECF No. 275. The court disagrees. First, as CapCall acknowledges, Mr. Hatzenbeller specifically testified that transactions with CapCall were rolled; this testimony was not rebutted by any other witness or challenged through cross-examination. Second, Mr. Hatzenbeller's testimony is corroborated by contemporaneous emails in which he and Mr. Leak are negotiating a "rolling" or "stacking" transaction. *See* Trial Ex. 129. Third, the absence of lump-sum payments in the Trustee's accounting of prepetition transfers does not prove that no "rolling" transactions happened – there is no reason why CapCall would need to advance 100% of the new money to the Shoot the Moon entity only to have the Shoot the Moon entity immediately pay some portion back to CapCall in satisfaction of the preexisting Merchant Agreement. Rather, as is typical in many debt refinancing transactions, CapCall could simply adjust the balances on its own books and transfer only the net amount of any new advance. In fact, this appears to be exactly what happened with the transaction Mr. Hatzenbeller and Mr. Leak were arranging. *See* Trial Exs. 109 at p.1 (new cash advance of nominal $175,000), 159 at p. bates stamped STM 004323 (July 2 credit to account of $136,541), 129 (Leak citing balance of preexisting agreement to be satisfied as $40,158 a couple days earlier, which would leave a net advance of approximately what was actually credited once the intervening days of ACH debits are subtracted from Leak's stated balance). In sum, the weight of the evidence supports a factual finding that the transactions to which Mr. Hatzenbeller testified occurred.

62 Some of the factors do not tilt in either direction or are irrelevant. For example, since CapCall purportedly bought "future" receivables (i.e., payments made by customers who ate at the restaurants after the transactions closed), there were no account debtors who could be investigated by CapCall.

63 Trial Ex. 105 at p. 3 § 1.9.

64 *Fireman's Fund Ins. v. Grover (In re Woodson Co.)*, 813 F.2d 266, 272 (9th Cir. 1987).

65 *See, e.g.*, *K9 Bytes, Inc. v. Arch Capital Funding, LLC*, 56 Misc. 3d 807, 817-18 (N.Y. Sup. Ct. 2017). The court finds unpersuasive CapCall's arguments and authorities regarding how transactions should be classified as sales when the buyer cannot "be assured of repayment, because its agreements are contingent on a merchant's success." *Id*. at 818. Many lenders are not "assured of repayment" if the borrower's business does not succeed. In countless chapter 11 and chapter 7 cases, unsecured and undersecured creditors have received cents on the dollar when a business they financed failed to blossom. In the context of a restaurant business such as Shoot the Moon, most of the value of the enterprise and the debtor's ability to generate liquidity for debt service depends on successful future operations. When operations are impacted – because the restaurant is no longer serving food that people want to eat, is unable to open due to governmental restrictions such as those occasioned by the COVID-19 situation, is impacted by broader economic or cultural

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shifts, or is affected by any of the many other events that can cause a deterioration in performance – many or all of the restaurant's creditors will likely suffer losses, particularly since food inventory and fixtures rarely have substantial residual liquidation value. The analysis should not focus on whether the counterparty is "assured of repayment" or depends "on a merchant's success," but instead on whether the counterparty's right to recovery is limited to a specific res of purchased assets. When the counterparty has a ***legal right*** to be paid in full by the business, the existence of that legal right would be indicative of a debtor-creditor relationship even if ***practical realization of that legal right*** is "contingent on a merchant's success" and hence not assured.

66 *See, e.g.*, *First Cmty. Bank v. Gaughan (In re Miller)*, 853 F.3d 508, 515-16 (9th Cir. 2017). This approach is not used everywhere. *See* *PNC Bank v. Sterba (In re Sterba)*, 852 F.3d 1175, 1177 & 1177 n.1 (9th Cir. 2017) (noting that "[w]hen it comes to conflicts of law, bankruptcy is a bit of an odd duck" and highlighting a circuit split regarding which choice-of-law rules should apply).

67 RESTATEMENT (SECOND) OF CONFLICT OF LAWS (Am. Law Inst. 1971) ("RESTATEMENT") § 187(2).

68 *Id*. § 187 cmts. e, g.

69 *See, e.g., id*. § 187 cmt. e. ("Prime objectives of contract law are to protect the justified expectations of the parties and to make it possible for them to foretell with accuracy what will be their rights and liabilities under the contract. These objectives may best be attained in multistate transactions by letting the parties choose the law to govern the validity of the contract and the rights created thereby."); § 188 cmt. b. (highlighting "the fact that in multistate cases it is essential that the rules of decision promote mutually harmonious and beneficial relationships in the interdependent community, federal or international").

70 Case law demonstrates that the choice-of-law analysis should be performed on a contract-by-contract basis when a dispute involves multiple contracts that are related but nevertheless separate. *See, e.g.*, *Barnes Grp., Inc. v. C & C Prods., Inc.*, 716 F.2d 1023, 1026-32 (4th Cir. 1983); *Discover Prop. & Cas. Ins. v. TETCO, Inc.*, 2014 WL 685367, at *4, 2014 U.S. Dist. LEXIS 20306, at *15-17 (D. Conn. Feb. 19, 2014); *In re Titanium Dioxide Antitrust Litig.*, 962 F. Supp. 2d 840, 862 (D. Md. 2013).

71 Cf. *Alexander v. Compton (In re Bonham)*, 229 F.3d 750, 765-67 (9th Cir. 2000) (outlining factors that could support substantive consolidation of separate legal persons in bankruptcy).

72 *See, e.g.*, Trial Ex. 105 at p. 5 § 4.8.

73 For example, CapCall points to two letters Mr. Leak signed that reference a series of four transactions recurring every two weeks. *See* Trial Exs. 140-141. The purpose of these letters is unclear as they do not request any action by the putative recipients or explain the details of any intended "information purpose." In any event, it is unclear whether these letters were actually sent to anyone, the letters are extrinsic to written agreements containing integration clauses, and the letters are facially inaccurate when describing the transactions as being "between your account holder, Ken Hatzenbeller, and CapCall." Indeed, one of the letters appears nonsensical as it is addressed to "Stockman Bank Account Manager." *See* Trial Ex. 141. Mr. Hatzenbeller's unrebutted testimony is that the Shoot the Moon entities never had accounts at Stockman Bank. It is difficult to draw much of consequence from these two documents and they are certainly not a sufficient basis on which to justify collapsing eighteen separately documented transactions.

74 There are many examples of transaction structures in which a single, backbone agreement is used to accommodate numerous individual transactions. Some exemplars include: revolving lines of credit, debt issuances in which a base indenture is coupled with supplemental indentures for specific issuances, commercial leasing in multiple locations subject to a master lease and individual location leases, derivative transactions using an ISDA master agreement and individual trade confirmations, law firm engagements

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utilizing a master retention agreement and separate addenda for each individual matter, and film distribution agreements whereby a uniform distribution agreement is supplemented with the details for individual films.

75 *See, e.g.*, Trial Ex. 105 at p. 5 § 4.5.

76 Although the court ultimately does not reach or decide this issue, the record contains evidence that could support a general invalidation of the New York choice-of-law provisions given the minimal bargaining leverage of Mr. Hatzenbeller and the "take-it-or-leave-it" basis on which the deals were offered to him. *See* RESTATEMENT § 187 cmt. b, illus. 3.

77 *Id*. § 187 cmt. g.

78 *Scarr v. Boyer*, 250 Mont. 248, 252, 818 P.2d 381 (1991).

79 *See, e.g.*, *Kaneff v. Del. Title Loans, Inc.*, 587 F.3d 616, 624 (3d Cir. 2009) (determining "that Pennsylvania's interest in the dispute, particularly its antipathy to high interest rates such as the 300.01 percent interest charged in the contract at issue, represents such a fundamental policy that we must apply Pennsylvania law"); *Fleetwood Servs., LLC v. Complete Bus. Sols. Grp., Inc.*, 374 F. Supp. 3d 361, 372 (E.D. Pa. 2019) (concluding that Texas usury law constituted a fundamental public policy of that state when applying Restatement section 187(2)(b)).

80 *See, e.g.*, Trial Ex. 152 (listing creditors that will receive significantly less than recovery in full, including various Montana business and governmental entities). *Cf.* *Colorado v. W. Sky Fin., L.L.C.*, 845 F. Supp. 2d 1178, 1181 (D. Colo. 2011) (observing, in litigation about allegedly improper lending practices, how "[t]he impact of the allegedly excessive charges was felt in Colorado").

81 This point is highlighted later in the Restatement. *See* RESTATEMENT § 188 cmt. c. ("So the state where a party to the contract is domiciled has an obvious interest in the application of its contract rule designed to protect that party against the unfair use of superior bargaining power."); *see also, e.g.*, *DJR Assocs., LLC v. Hammonds*, 241 F. Supp. 3d 1208, 1232 n.11 (N.D. Ala. 2017) ("[A]n operating principle the court must respect is that each state is entitled to determine its own policies, and no state may insist that its laws be applied within other states to the exclusion of the power of such other states to decide for themselves what is good policy for regulating economic relationships within their own borders."); *Ribbens Int'l, S.A. de C.V. v. Transp. Int'l Pool, Inc.*, 47 F. Supp. 2d 1117, 1123 (C.D. Cal. 1999) (noting, during choice-of-law analysis, that "California, on the other hand, maintains a weighty and substantial interest in regulating commercial transactions that take place within its border").

82 RESTATEMENT § 188(1).

83 *Id*. § 188(2).

84 *Id*.

85 *Id*. cmt. c.

86 *Bixler v. Next Fin. Grp., Inc.*, 858 F. Supp. 2d 1136, 1143 (D. Mont. 2012).

87 RESTATEMENT § 188 cmt. e. (explaining that "the place of contracting is the place where occurred the last act necessary ... to give the contract binding effect" and that the place of negotiation "is of less importance when there is no one single place of negotiation and agreement, as, for example, when the parties do not meet but rather conduct their negotiations from separate states by mail or telephone").

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88 *See, e.g.*, Trial Ex. 130.

89 *See* Trial Exs. 102 at p. 1, 103 at p. 1, 104 at p. 1, 106 at p. 1, 109 at p. 1, 110 at p. 1, 111 at p. 1, 113 at p. 1, 115 at p. 1 (note that this agreement erroneously identifies the particular Shoot the Moon entity as being organized in Idaho despite CapCall contracting with that entity and correctly identifying it as a Montana entity twice before, see Trial Exs. 103, 104), 116 at p. 1, 118 at p. 1, 204, 205, 209, 210, 211.

90 *Cf.* *Casarotto v. Lombardi*, 268 Mont. 369, 373-75, 886 P.2d 931 (1994) (applying Restatement sections 187(2)(b) and 188 and concluding that Montana law applied to franchise dispute when franchisee restaurant would be operated in Great Falls by Great Falls residents and the primary connection to a different state was that the franchisor "was incorporated in that state and apparently had its home office in that state at the time of the parties' agreement"), *rev'd on other grounds sub nom.* *Doctor's Assocs. Inc. v. Casarotto*, 517 U.S. 681, 116 S.Ct. 1652, 134 L.Ed.2d 902 (1996).

91 *See* Mont. Code Ann. § 31-1-111 (defining "regulated lender"). CapCall does not contend it qualifies as a "regulated lender" and the record contains no evidence supporting such qualification.

92 *Id.* § 31-1-107(1).

93 *See id.* § 31-1-108(1), (2).

94 *Scarr*, 250 Mont. at 253, 818 P.2d 381. *See also* *Bowden v. Gabel*, 105 Mont. 477, 477, 76 P.2d 334 (1937).

95 Mont. Code Ann. § 31-1-108(2).

96 *See* Trial Ex. 146.

97 *See* Trial Ex. 145. Although CapCall did not make any argument regarding the special usury rule in Restatement section 203, the court notes that the effective interest rates Ms. Manos calculated (between 82.7% at the low end and 175.13% at the high end) are many multiples of the permissible 15% and therefore are "greatly in excess of the rate permitted by the general usury law of the state of the otherwise applicable law under the rule of § 188." RESTATEMENT § 203.

98 Ms. Manos' approach to calculating the applicable interest rates squares with the broad statutory definition of interest as any "compensation allowed by law or fixed by the parties for the use or forbearance or detention of money and includes loan origination fees, points, and prepaid finance charges, as defined in 12 CFR 226.2." Mont. Code Ann. § 31-1-104. *See also, e.g.*, *Brummer v. TMG Life Ins. Co. (In re Brummer)*, 147 B.R. 552, 558-59 (Bankr. D. Mont. 1992) (discussing how amounts are treated as interest under this statute "[r]egardless of the label used" if "the substance of the transaction" is to compensate the lender for an advance of money).

99 *Cf. In re Dale*, 2021 Bankr. LEXIS 348, at *8-10 (Bankr. D. Mont. Feb. 12, 2021) (reducing usury penalty based on equitable considerations including the document drafting history and the parties' relative business experience).

100 *Scarr*, 250 Mont. at 252, 818 P.2d 381.

101 *See, e.g.*, *Union Bank v. Wolas*, 502 U.S. 151, 160-61, 112 S.Ct. 527, 116 L.Ed.2d 514 (1991).

102 *Cent. Va. Cmty. Coll. v. Katz*, 546 U.S. 356, 372, 126 S.Ct. 990, 163 L.Ed.2d 945 (2006).

103 *See, e.g.*, 11 U.S.C. § 547(g); *Batlan v. TransAm. Com. Fin. Corp. (In re Smith's Home Furnishings, Inc.)*, 265 F.3d 959, 967 (9th Cir. 2001).

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104 The Small Business Reorganization Act of 2019 amended section 547(b) to require "reasonable due diligence in the circumstances of the case and taking into account a party's known or reasonably knowable affirmative defenses under subsection (c)" as part of a trustee's prima facie case. The legislation was not effective until after the relevant time period here and was not retroactive regarding pending preference claims.

105 *United States v. Daniel (In re R & T Roofing Structures & Com. Framing)*, 887 F.2d 981, 984 (9th Cir. 1989).

106 *See* Trial Ex. 144. Ms. Manos testified that she prepared this document after evaluating the underlying bank statements. See Trial Exs. 158-160.

107 *See Foster v. IOU Cent., Inc. (In re Shoot the Moon, LLC)*, 2020 WL 2621173, at *5, *8-9, 2020 Bankr. LEXIS 1374, at *13-16, *26-29 (Bankr. D. Mont. May 21, 2020).

108 The court has a different perspective regarding another aspect of Judge Myers' opinion, which deals with an argument that CapCall generally deploys based on anti-assignment provisions in the Merchant Agreements. *See, e.g.*, Trial Ex. 105 at p. 5 § 4.2 (precluding the Shoot the Moon entity "from transferring or assigning this Agreement, or any of its rights or obligations hereunder, without [CapCall]'s written consent"). Judge Myers concluded that "rights are generally assignable unless the contract provides otherwise or an exception applies" and "the right to avoid a preferential transfer or challenge allegedly usurious interest rates does not fall into the enumerated exceptions." *See* 2020 WL 2621173, at *5, 2020 Bankr. LEXIS 1374, at *12. The right to avoid a preference, however, was never one the debtor enjoyed – preference actions are creatures of the Bankruptcy Code that exist only postpetition for the benefit of the estate, not the debtor, and hence are unaffected by prepetition acts of the debtor. *See, e.g.*, *Cont'l Ins. v. Thorpe Insulation Co. (In re Thorpe Insulation Co.)*, 671 F.3d 1011, 1026 (9th Cir. 2012) (explaining how "purported prepetition waivers of the protections of the Bankruptcy Code" are generally unenforceable); *Bakst v. Bank Leumi, USA (In re D.I.T., Inc.)*, 575 B.R. 534, 536 (Bankr. S.D. Fla. 2017) (describing how various nonbankruptcy defenses, such as *in pari delicto*, "may not be raised in response to an action brought by the estate representative under the provisions of the Bankruptcy Code itself, including fraudulent transfer and preference actions"). Additionally, neither a preference claim nor a Montana usury claim is a right arising under or pursuant to the Merchant Agreements. Rather, both rights are the product of statutory regimes that exist apart from the agreements. Because the Trustee is not seeking to assert any of the Shoot the Moon entities' "rights or obligations hereunder," the anti-assignment provisions in the Merchant Agreements are irrelevant to the preference and usury claims.

109 *See, e.g.*, *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 204-05, 103 S.Ct. 2309, 76 L.Ed.2d 515 (1983).

110 *Begier v. IRS*, 496 U.S. 53, 58, 110 S.Ct. 2258, 110 L.Ed.2d 46 (1990). *See also, e.g.*, *United States v. Sims (In re Feiler)*, 218 F.3d 948, 953 (9th Cir. 2000) (explaining that avoidance actions allow "a trustee to avoid transfers of property that should have been the property of the estate, but for an improper transfer"); *Mardick v. Stover*, 392 F.2d 561, 565 (9th Cir. 1968) (discussing how "the concept of voidable preference" is intended to capture "property of any bankrupt which would, but for transfer, have constituted part of his estate").

111 *See, e.g.*, *Adams v. Anderson (In re Superior Stamp & Coin Co.)*, 223 F.3d 1004, 1007 (9th Cir. 2000).

112 *See* 11 U.S.C. § 101(5)(A), (10)(A) (defining the terms "claim" and "creditor").

113 *See id*. § 101(12) (defining the term "debt").

114 *See id*. § 547(f).

115 *See* Trial Ex. 157.

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116 *See* Trial Ex. 144.

117 *Alvarado v. Walsh (In re LCO Enters.)*, 12 F.3d 938, 941 (9th Cir. 1993).

118 *See* 11 U.S.C. § 721.

119 *See id*. § 704(a)(1).

120 *See* Trial Ex. 152 (column for claims that were "Secured Converted to Unsecured after Sale Closure," which include deficiency claim amounts significantly in excess of the aggregate amount of the CapCall transfers).

121 *See* 11 U.S.C. § 506(a).

122 *See, e.g.*, *Am. Honda Fin. Corp. v. A. Angelle, Inc. (In re A. Angelle, Inc.)*, 230 B.R. 287, 300 (Bankr. W.D. La. 1998) (concluding that greater amount test was satisfied when the transferee "did not enjoy a senior secured position with respect to [the collateral], nor to the proceeds resulting from the sale thereof, and, accordingly, was not fully secured with respect to that transfer").

123 Suppl. Post Trial Br. 8, ECF No. 275.

124 11 U.S.C. § 506(a).

125 *See id*. § 506(d).

126 *See id*. § 552(a)-(b)(1); see also, e.g., *Fin. Oversight & Mgmt. Bd. for P.R. v. Andalusian Glob. Designated Activity Co. (In re Fin. Oversight & Mgmt. Bd. for P.R.)*, 948 F.3d 457, 466-72 (1st Cir.), *cert. denied*, —— U.S. ——, 141 S. Ct. 844, 208 L.Ed.2d 422 (2020); *Sims v. Jamison*, 67 F.2d 409, 411 (9th Cir. 1933).

127 It bears noting that CapCall could have avoided the position in which it now finds itself. Mr. Marmott testified that he is familiar with the operation of UCC-1 financing statements and that it is standard practice in the industry for merchant cash advance parties to file such financing statements. If it is not industry practice to perform a precautionary search for other financing statements before making a cash advance, it certainly should be. Had CapCall performed such a search, CapCall likely would have realized that there were preexisting lenders with first-in-time financing statements encumbering all assets of the relevant Shoot the Moon entities, including their accounts receivable, which may have deterred CapCall from engaging in the transactions.

128 11 U.S.C. § 550(d).

129 *See, e.g.*, *Samson v. W. Cap. Partners, LLC (In re Blixseth)*, 489 B.R. 154, 202 (Bankr. D. Mont. 2013) (describing similar issue when there was an overlap between amounts recoverable based on fraudulent transfer theory and amounts recoverable under the Montana usury statute), aff'd, 514 B.R. 871 (D. Mont. 2014), aff'd in part, rev'd in part, 679 F. App'x 611 (9th Cir. 2017) (the basis for reversal related to a totally separate issue).

130 In its post-trial submission, CapCall contends that "there are no claims either pleaded or proofs offered toward claims of lien stripping under 11 U.S.C. § 506(d)." Suppl. Post Trial Br. 7, ECF No. 275. Regarding the former point, CapCall is correct that the Trustee did not plead a formal count under Bankruptcy Code section 506(d). It is unclear that such formal pleading is necessary, however; section 506(d) by its terms is self-operative when it declares that a lien falling within its scope "is void" as opposed to being potentially "voidable" through litigation. *Compare* 11 U.S.C. § 506(d), *with, e.g., id*. §§ 544(a)-(b)(1), 545, 547(b), 548(a)-(c), 549(a); *see also, e.g., id*. § 551 (clearly differentiating between a transfer that "is avoided" under various sections and "any lien void under section 506(d)"); *Bank of N.Y. Mellon v. Enchantment at Sunset Bay Condo. Ass'n*, 2 F.4th

1229, 1235-37 (9th Cir. 2021) (VanDyke, J., concurring) (tracing historical distinction between the separate concepts of "void" and "voidable" in the context of the automatic stay; noting that "[i]f a transaction is void, it is null—it is as if it never existed"). In any event, the Trustee's position throughout this litigation has been that CapCall's potential collateral is unencumbered property of the estate, which necessarily challenges any lien that CapCall asserts. *See, e.g.*, Def.'s Countercl. 11 ¶ 45, ECF No. 17; Final Pretrial Order 8-9, 24, ECF No. 260. Regarding the latter point, CapCall is incorrect that there were no "proofs offered" in support of lien-stripping – the Trustee introduced clear evidence, which CapCall failed to rebut, demonstrating the existence of senior liens on all of CapCall's collateral and that those senior liens are undersecured, which is all the proof necessary to leave CapCall with no allowable secured claim under Bankruptcy Code section 506(a) and hence only void liens under section 506(d).

131 Adding to these considerations, CapCall is also bound by the terms of the confirmed plan providing that "[a]ny creditor with a lien that no longer has any value will become a general unsecured creditor." *See* I*n re Shoot the Moon, LLC*, No. 2:15-bk-60979-WLH (Bankr. D. Mont.), Plan of Liquidation § 3.9, ECF No. 1056; *see also id*. § 1.0 (advising parties to carefully review the disclosure statement and evaluate "the impact of the plan upon your claims or security interests" (all-caps font removed)). CapCall received notice of the plan and had participated in the Shoot the Moon bankruptcy (including through the stipulation regarding the segregated funds and by filing a proof of claim) and thus CapCall is bound by the plan as well as by Bankruptcy Code section 1141(c)'s generalized free-and-clear provision. *See* 11 U.S.C. § 1141(c) (providing that, subject to certain inapplicable exceptions, "except as otherwise provided in the plan or in the order confirming the plan, after confirmation of a plan, the property dealt with by the plan is free and clear of all claims and interests of creditors, equity security holders, and of general partners in the debtor"). The segregated account is "dealt with" in section 2.15 of the confirmed plan, which transfers "all remaining assets of the Estate" to the STM Liquidating Trust. *See also* Trial Ex. 155 § 2.2. Given the terms of the confirmed plan and CapCall's participation in the bankruptcy case, this is not a context where the "ride through" doctrine has any application. *See, e.g.*, *Acceptance Loan Co. v. S. White Transp., Inc. (In re S. White Transp., Inc.)*, 725 F.3d 494, 496 (5th Cir. 2013); *In re Penrod*, 50 F.3d 459, 461-64 (7th Cir. 1995). The unpublished case CapCall cites regarding the "ride through" doctrine is distinguishable because that litigation arose from a chapter 7 case in which there was no plan and no role for section 1141(c). *See Nagata v. HFS Fed. Credit Union (In re Nagata)*, 2006 WL 2131318, at *2, 2006 Bankr. LEXIS 1634, at *2, *6-7 (Bankr. D. Haw. July 20, 2006).

132 *See* 11 U.S.C. § 502(d).

133 The Trustee argued in post-trial briefing that the court should equitably subordinate all of CapCall's claims pursuant to Bankruptcy Code section 510(c). *See* Trustee's Post-Trial Br. 13-16, ECF No. 274. The court need not reach the details of this theory because counsel withdrew the new claim during closing argument and acknowledged that the issue was not raised before trial. *See, e.g.*, *Greenstar, LLC v. Heller*, 934 F. Supp. 2d 672, 696 (D. Del. 2013).

134 Mont. Code Ann. § 28-3-704(1). As with the Montana usury statute, the policy purposes served by Montana's reciprocal fee statute are expansive and grounded in protecting parties with inferior bargaining power from contractual overreaching, which means the fee statute likewise represents a fundamental policy of the state for purposes of any choice-of-law analysis. *See, e.g.*, *Medcorp Int'l, L.L.C. v. Leslie*, 1998 WL 657770, at *3, 1998 U.S. App. LEXIS 21714, at *14 (9th Cir. Sept. 3, 1998).

135 *See* Trial Exs. 102 at p. 5 §§ 3.2-3.3, 103 at p. 5 §§ 3.2-3.3, 104 at p. 5 §§ 3.2-3.3, 106 at p. 5 §§ 3.2-3.3, 109 at p. 5 §§ 3.2-3.3, 110 at p. 5 §§ 3.2-3.3, 111 at p. 5 §§ 3.2-3.3, 113 at p. 5 §§ 3.2-3.3, 115 at p. 5 §§ 3.2-3.3, 116 at p. 5 §§ 3.2-3.3, 118 at p. 2 §§ 3.2-3.3.

136 This reciprocal right is one arising under Montana statute, not under the Merchant Agreements themselves. As such, the anti-assignment provisions in the Merchant Agreements are not violated by their own terms

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and do not bear on the Trustee's ability to assert a claim to reciprocal attorneys' fees as successor to the applicable Shoot the Moon entities. See note 108, supra.

137 *See, e.g.*, *Gandy v. Eschler*, 261 Mont. 355, 360-61, 862 P.2d 1116 (1993); *Carey v. Wallner*, 223 Mont. 260, 267, 725 P.2d 557 (1986); *Preston v. McDonnell*, 203 Mont. 64, 68, 659 P.2d 276 (1983); *Bartmess v. Bourassa*, 196 Mont. 231, 234, 639 P.2d 1147 (1982); *see also generally* *Dickman v. Ford New Holland*, 1993 WL 430044, at *2, 1993 U.S. App. LEXIS 28731, at *6-7 (9th Cir. Oct. 25, 1993) (describing how "the Montana Supreme Court has construed" fee-shifting provisions such as section 28-3-704 "very liberally").

138 *Penrod v. AmeriCredit Fin. Servs. (In re Penrod)*, 802 F.3d 1084, 1088 (9th Cir. 2015). See also, e.g., *Heritage Ford v. Baroff (In re Baroff)*, 105 F.3d 439, 442-43 (9th Cir. 1997).

139 *See* *In re Penrod*, 802 F.3d at 1088-89.

140 *See* *id*. at 1090.

141 *In re Mac-Go Corp.*, 541 B.R. 706, 715 (Bankr. N.D. Cal. 2015).

142 *See, e.g.*, *Transaction Network v. Wellington Techs.*, 301 Mont. 212, 221, 7 P.3d 409 (2000); *Majers v. Shining Mountains*, 230 Mont. 373, 380, 750 P.2d 449 (1988).

143 Trustee's Post-Trial Br. 13, ECF No. 274. Pursuant to Federal Rule of Evidence 201(c)(1) & (d), the court takes judicial notice of the fee agreement containing the 40% contingency amount, which was filed and approved in the underlying bankruptcy case. *See In re Shoot the Moon, LLC*, No. 2:15-bk-60979-WLH (Bankr. D. Mont.), ECF Nos. 1052, 1072.

144 *Weinberg v. Farmers State Bank*, 231 Mont. 10, 34, 752 P.2d 719 (1988), superseded by statute on other grounds, Mont. Code Ann. § 27-1-220(1), as recognized in *Folsom v. Mont. Pub. Emps. Ass'n*, 388 Mont. 307, 400 P.3d 706 (2017). *See also, e.g.*, *West v. Club at Spanish Peaks L.L.C.*, 343 Mont. 434, 460-62, 186 P.3d 1228 (2008) (affirming use of 40% contingency fee arrangement to calculate reasonable fee for the prevailing party).

145 *See* *Weinberg*, 231 Mont. at 35, 752 P.2d 719 (quoting factors as "the amount and character of the services rendered; the labor, time, and trouble involved, the character and importance of litigation in which the services were rendered, the amount of money or the value of property to be affected, the professional skill and experience called for, the character and standing in the profession of the attorneys; ... the result secured by the services of the attorneys may be considered as an important element in determining their value").

146 The complexity associated with this litigation is amplified somewhat by the assignment of three different bankruptcy judges to the Shoot the Moon bankruptcy case. Whenever a new judge, such as the undersigned, takes over, there is additional work counsel must do to familiarize that judge with past events bearing on the litigation. The Trustee's counsel has done a fine job here.

147 For example, a 40% fee regarding the usury penalty would by itself equal 80% of the interest CapCall was paid in the first instance.

148 To be clear, this is the amount that the Trustee is entitled to include in a judgment against CapCall pursuant to Montana Code section 28-3-704. The amount that the Trustee's counsel is entitled to receive for payment of their services is a separate matter governed by the terms of the operative agreement with the Trustee.

149 *See* *Masters Grp. Int'l, Inc. v. Comerica Bank*, 404 Mont. 434, 471 (2021).

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NOT FOR PUBLICATION
United States Bankruptcy Appellate
Panel of the Ninth Circuit.

IN RE: ENPARK LANDSCAPE, LLC, Debtor.
Enpark Landscape, LLC, Appellant,
v.
AKF, Inc. dba FundKite, Appellee.

BAP No. NV-23-1182-PLC
|
Bk. No. 23-11145-abl
|
Filed September 27, 2024

Appeal from the United States Bankruptcy Court for the District of Nevada, August B. Landis, Chief Bankruptcy Judge, Presiding

Attorneys and Law Firms

Carlos R. Hernandez-Vivoni, United States Department of Justice, United States Trustee, Region 17, Las Vegas, NV, for U.S. Trustee.

Matthew C. Zirzow, Larson and Zirzow, LLC, Las Vegas, NV, for Debtor.

Before: PEARSON[1], LAFFERTY, and CORBIT, Bankruptcy Judges.

MEMORANDUM[*]

INTRODUCTION

***1** Debtor Enpark Landscape, LLC ("Enpark") appeals the bankruptcy court's order allowing the secured claim filed by creditor AKF, Inc., dba FundKite.

FundKite timely filed a proof of claim in Enpark's chapter 11[2] bankruptcy case and supported its claim with two documents: (i) a Revenue Purchase Agreement executed by FundKite as the purported purchaser of some of Enpark's accounts; and (ii) a Settlement Agreement entered into by the parties shortly before Enpark's bankruptcy filing that purported to resolve disputes between them arising from Enpark's default under the Revenue Purchase Agreement.

Enpark objected to FundKite's claim, focusing primarily on whether the Revenue Purchase Agreement was enforceable. Specifically, Enpark argued that, rather than an agreement to purchase some of Enpark's accounts receivable, the Revenue Purchase Agreement was, under applicable non-bankruptcy law, actually a disguised loan, and a criminally usurious one at that. In making this argument, Enpark highlighted the plethora of cases in New York and elsewhere that have concluded that agreements like the Revenue Purchase Agreement are, in fact, loans, and subject to attack under the state's usury laws.

The bankruptcy court overruled the objection based upon the longstanding and generally applicable doctrine that courts should honor settlement agreements, and accord them finality. Although the court indicated that its cursory examination of the Revenue Purchase Agreement gave it concerns about the enforceability of the agreement, the court ultimately decided that it was required to focus solely on the Settlement Agreement and honor the parties' putative intent to resolve their disputes per that agreement.

In so ruling, the bankruptcy court made two critical determinations that the Panel believes were erroneous. First, although the FundKite claim as filed was supported by the Revenue Purchase Agreement as well as the Settlement Agreement, the bankruptcy court at least nominally chose to rely solely on the Settlement Agreement and determined that the Settlement Agreement provided sufficient factual support for the filed claim. We believe that this determination was in error. In this instance, the Settlement Agreement simply did not provide enough information about FundKite's right to payment to permit the bankruptcy court to allow FundKite's secured claim relying on the Settlement Agreement alone.

Second, if an objection is made to a claim, the Bankruptcy Code requires the court to determine whether the claim is "unenforceable ... against the debtor ... under any ... applicable law." § 502(b)(1). In relying solely on the Settlement Agreement, the bankruptcy court declined to address issues raised by Enpark regarding the enforceability of FundKite's claim. Although Enpark's objection did not cite relevant applicable **non-bankruptcy law** – New York law – regarding the enforceability of the **Settlement Agreement**, in light of our decision to remand this matter to the bankruptcy court based on the court's erroneous determination that the

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Settlement Agreement itself provided sufficient support for the claim, we believe that the court must also consider and address arguments regarding the enforceability of FundKite's claim.

***2** Therefore, we VACATE the bankruptcy court's ruling and REMAND this matter for further proceedings consistent with this decision.

FACTS[3]

In December 2022, Enpark entered into a Revenue Purchase Agreement with FundKite, in which FundKite purchased $344,448 of Enpark's future receipts for $249,600. To satisfy its obligation to FundKite, Enpark was required to pay 13% of its receipts to FundKite each week until it had paid FundKite the $344,448 plus any outstanding fees. FundKite also took a security interest in Enpark's accounts to secure Enpark's obligations.

Enpark concedes that it defaulted on the Revenue Purchase Agreement. FundKite then sought enforcement in arbitration and also sought the aid of a New York state court to restrain Enpark's use of its receivables pending arbitration.

Before the hearing on the order to show cause in the state court action, Enpark and FundKite entered into the Settlement Agreement, with an effective date of March 6, 2023. A stipulation of settlement was filed with, but not approved by, the New York state court. The Settlement Agreement required Enpark to make certain payments to FundKite, in an amount and on a schedule modified from the Revenue Purchase Agreement.

After complying with the initial obligations of the Settlement Agreement, Enpark soon thereafter defaulted. Enpark filed its chapter 11 bankruptcy case on March 27, 2023.

FundKite filed a proof of secured claim. FundKite's proof of claim was properly executed, and included Official Form 410, a copy of a UCC-1 financing statement that listed Enpark as debtor, a copy of the Settlement Agreement, and a copy of the Revenue Purchase Agreement. Enpark objected to the proof of claim.

The bankruptcy court, relying upon the written records in the case, and considering the arguments of counsel, orally ruled to allow FundKite's claim. The bankruptcy court held that FundKite's proof of claim complied with the requirements of the Bankruptcy Code and Rules, and that the claim was prima facie valid. The bankruptcy court also acknowledged that if the underlying Revenue Purchase Agreement were the basis of the claim, Enpark's objection contained "probative force equal to that of the allegations of the proof of claim." However, the bankruptcy court held that the proof of claim was based on the Settlement Agreement. The bankruptcy court opined that settlement agreements are favored by the law and concluded that it would not look behind the terms of the Settlement Agreement. The bankruptcy court, in its oral ruling, said that "[t]he Court is looking at the settlement agreement as the basis for the proof of claim and whether or not the settlement agreement can provide support under New York law for the proof of claim itself, and I find that it can." In so concluding, the bankruptcy court necessarily found that the Settlement Agreement contained sufficient information and support to demonstrate that FundKite had an allowable secured claim before considering whether, for other reasons, the claim would be enforceable under applicable law.

***3** Enpark asserts that the bankruptcy judge made an alternative ruling that the underlying Revenue Purchase Agreement was enforceable, and criticizes the bankruptcy court for failing to provide any analysis. FundKite insists that the bankruptcy court made no such alternative ruling and relied solely on the Settlement Agreement. While not entirely clear, the bankruptcy court stated that it was relying on the Settlement Agreement alone in reaching its decision, and the court did not appear to refer to any provisions of the Revenue Purchase Agreement in overruling the objection. Accordingly, the bankruptcy court did not appear to decide whether the underlying Revenue Purchase Agreement was actually a loan, and if it were a loan, if it were criminally usurious, and if so, what impact that would have on the enforceability of the Settlement Agreement.

On November 1, 2023, the bankruptcy court entered its written Order Overruling Objection to Claim. Later that day, Enpark appealed.

JURISDICTION

The bankruptcy court had jurisdiction over this case pursuant to 28 U.S.C. §§ 1334(a) and 157(a), and Rule 1001(b)(1) of the Local Rules of Bankruptcy Practice of the United States Bankruptcy Court, District of Nevada.[4] This matter is a core proceeding under 28 U.S.C. § 157(b)(2)(B). We have

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jurisdiction over the bankruptcy court's determination under 28 U.S.C. § 158(a)(1).

ISSUES

Did the bankruptcy court err in relying exclusively on the Settlement Agreement to overrule Enpark's objection to FundKite's claim, including determining the Settlement Agreement alone adequately supported FundKite's proof of claim?

Did the bankruptcy court err in failing to analyze the enforceability of FundKite's claim under applicable nonbankruptcy law?

STANDARD OF REVIEW

In the context of a claim objection, we review the bankruptcy court's legal conclusions de novo and its findings of fact for clear error. *Lundell v. Anchor Constr. Specialists, Inc.*, 223 F.3d 1035, 1039 (9th Cir. 2000). The bankruptcy court's ruling purely on the sufficiency of the proof of claim, including its finding that the Settlement Agreement contained sufficient information to support the proof of claim, is reviewed for clear error.

The bankruptcy court's legal conclusions – such as its holding that it could not consider any documents other than the Settlement Agreement and its interpretation of New York law regarding the enforceability of settlement agreements – are questions of law that we review de novo. *See Renwick v. Bennett (In re Bennett)*, 298 F.3d 1059, 1064 (9th Cir. 2002) (applying state law); *MPEG LA, LLC v. Samsung Elecs. Co.*, 166 A.D.3d 13, 17, 86 N.Y.S.3d 4, 8 (App. Div. 2018) (similar rule in New York). When we conduct a de novo review, "we look at the matter anew, the same as if it had not been heard before, and as if no decision previously had been rendered, giving no deference to the bankruptcy court's determinations." *Charlie Y., Inc. v. Carey (In re Carey)*, 446 B.R. 384, 389 (9th Cir. BAP 2011).

DISCUSSION

A proof of claim is deemed allowed unless a party in interest objects to the claim. § 502(a). When an objection to claim is filed, the objecting party must "produce evidence and show facts tending to defeat the claim by probative force equal to that of the allegations" of the proof of claim. *Wright v. Holm (In re Holm)*, 931 F.2d 620, 623 (9th Cir. 1991) (citation omitted). If the objecting party produces such facts, the burden of proof shifts to the claimant to "prove the validity of the claim by a preponderance of the evidence." *Lundell*, 223 F.3d at 1039 (citation omitted). The claimant has the ultimate burden of persuasion. *Id.*

The court must then determine the amount of the claim and (with exceptions not relevant here) "allow such claim in such amount, except to the extent that... such claim is unenforceable against the debtor and property of the debtor, under any agreement or applicable law for a reason other than because such claim is contingent or unmatured." § 502(b)(1). Any dispute over a claim in bankruptcy based on contract law is governed by relevant state law unless the Bankruptcy Code specifically states otherwise. *Merced Prod. Credit Assoc. v. Sparkman (In re Sparkman)*, 703 F.2d 1097, 1099 (9th Cir. 1983).[5]

***4** Enpark objected to FundKite's claim, primarily challenging the enforceability of the Revenue Purchase Agreement under New York law. Notwithstanding this objection, the bankruptcy court made two findings it believed militated against disallowance of FundKite's claim.

First, the court found that FundKite's claim was based entirely on the Settlement Agreement, and that the Settlement Agreement sufficiently established FundKite's right to payment. As set forth below, we disagree and we question the effectiveness of the Settlement Agreement in light of its language concerning the effect of filing for bankruptcy.

Second, the bankruptcy court concluded that it would not adjudicate Enpark's arguments regarding the validity of the Revenue Purchase Agreement because settlement agreements are generally favored and enforceable under New York state law. The bankruptcy court interpreted this law as prohibiting any evaluation of the underlying facts leading to entry of the Settlement Agreement.

While we acknowledge the importance of honoring settlement agreements as a matter of sound judicial policy, we do not believe that any such policy prohibits looking behind such agreements to determine the true nature of a debt in the claims allowance process. Absent a bankruptcy-based restriction on looking behind settlement agreements in claims allowance, which we believe case law does not

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support, we believe that on remand the parties may raise, and the bankruptcy court may consider, arguments based on applicable non-bankruptcy law regarding the appropriate tests for when a court should look beyond a settlement agreement to determine the enforceability of the underlying transaction.

A. The bankruptcy court's finding that the Settlement Agreement alone established FundKite's secured claim was clear error.

In its ruling, the bankruptcy court agreed with FundKite that the proof of claim was based solely on the Settlement Agreement. However, the Settlement Agreement, standing alone, could not have supported FundKite's claim.

First, and most conspicuously, although FundKite asserted that its claim was secured, and the bankruptcy court agreed and allowed the claim as secured, nothing in the Settlement Agreement so much as referred to a basis for the assertion of a secured claim, let alone contained or referred to evidence of a grant of security in favor of FundKite, or the perfection of any such interest. The only grant of a security interest from Enpark to FundKite in the record is in the Revenue Purchase Agreement. In fact, FundKite itself attached the Revenue Purchase Agreement to the official claim form, presumably for the purpose of establishing that its claim was secured.

Moreover, it is questionable whether the Settlement Agreement even governs this claim. The Settlement Agreement provides the following:

> 9. Bankruptcy action. In the event that a petition for bankruptcy relief, whether voluntary or involuntary, is filed by or relating to any Defendant [Enpark] prior to the expiration of ninety-one (91) days after Plaintiff [FundKite] receives the final Settlement Payment, **this Agreement shall be of no effect as to such Defendant filing Bankruptcy**, and Plaintiff shall be entitled to assert a claim in such bankruptcy proceeding....

(Emphasis added).

***5** Read most plainly, paragraph 9 of the Settlement Agreement indicates that the Settlement Agreement will not be enforceable between FundKite and Enpark if Enpark files bankruptcy. We note that the relevant language does **not** provide that "at the option of the creditor" (here, FundKite) the Settlement Agreement may be unenforceable should Enpark file for bankruptcy. Nor does it provide that should Enpark file for bankruptcy, FundKite is not bound by any financial accommodations made in the Settlement Agreement pertaining to the amount of the debt or timing of payment. Rather, it appears the parties may have bargained for a more absolute result, i.e., for the outcome that the Revenue Purchase Agreement, **not the Settlement Agreement**, would be the controlling agreement if Enpark filed bankruptcy.

At oral argument, the Panel inquired of counsel for the parties whether the issue of the applicability or effect of paragraph 9 of the Settlement Agreement had been argued to the bankruptcy court; counsel indicated that it had not. And it appears from the bankruptcy court's oral ruling that the court neither mentioned nor evaluated the effect of this provision.[6] On remand, the bankruptcy court should consider these issues.

As provided in greater detail in section B, the bankruptcy court concluded that the mere existence of the Settlement Agreement meant that the court was prohibited from assessing other documents submitted in support of FundKite's claim. However, while the court may ultimately decide that the Settlement Agreement remains binding and enforceable, nothing prevented the bankruptcy court from looking behind the Settlement Agreement to decide the nature of FundKite's claim. In light of the above, the bankruptcy court's finding that the Settlement Agreement formed the sole basis of FundKite's claim was clear error.[7]

B. The Settlement Agreement did not present a bar to the bankruptcy court analyzing the enforceability of the Settlement Agreement and the Revenue Purchase Agreement under New York law.

As discussed above, we believe that the bankruptcy court erred in finding that the Settlement Agreement alone formed the basis of FundKite's claim. However, the bankruptcy court also did not fully consider applicable New York law regarding the enforceability of the Settlement Agreement.

***6** As a preliminary matter, we acknowledge that Enpark's legal theories regarding invalidation of the Settlement Agreement left much to be desired. Although Enpark referenced New York law to advance its theories regarding invalidation of the **Revenue Purchase Agreement**, Enpark relied exclusively on federal law in support of its arguments regarding the validity of the **Settlement Agreement**. We agree with the bankruptcy court that Enpark mistakenly relied on *Archer v. Warner* in support of its position that the Settlement Agreement is not enforceable. 538 U.S. 314 (2003).[8] *Archer* provided that the existence of a prepetition

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settlement agreement may not shield from the bankruptcy court's inquiry the nature of a prepetition debt, i.e., whether a debt should be excepted from discharge under § 523(a), a holding not relevant to this case.

Nevertheless, *Archer* does stand for the proposition that bankruptcy courts may look beyond a settlement agreement to determine the nature of a claim; more simply, *Archer* provides that there is no overall bankruptcy law prohibition on looking past a settlement agreement in performing a central purpose of the bankruptcy laws, including the allowance of claims. *Id.* at 323.

As expressly declared by the language of § 502(b)(1), in the claims allowance process, the enforceability of a claim must be assessed under "any ... applicable law"—here, New York law. Enpark expressly and vigorously challenged the validity and enforceability of both the Revenue Purchase Agreement and the Settlement Agreement by asserting that the Revenue Purchase Agreement was a disguised loan with a criminally usurious interest rate and, therefore, void. This challenge to FundKite's claim presented a serious issue regarding the enforceability of the Revenue Purchase Agreement under New York law. Enpark's misplaced reference to federal law notwithstanding, a review of New York law pursuant to § 502(b)(1) would have revealed state law support for Enpark's theory. Under *Archer* and § 502(b)(1), nothing prohibited the bankruptcy court from considering such authorities.

To be sure, the bankruptcy court did reference New York law for the basic proposition that settlement agreements are favored by New York courts and are not lightly cast aside. *See Stein v. Stein*, 12 N.Y.S.3d 284, 286 (NY App. Ct. 2015).[9] However, this general policy does not translate to a *per se* rule that settlement agreements are **never** invalidated under New York law, nor does it necessarily prevent the bankruptcy court from considering all of the documents and information in support of FundKite's claim prior to adjudicating the enforceability of that claim.

Because Enpark argued that the Revenue Purchase Agreement is void as criminally usurious, on remand, nothing prohibits the bankruptcy court from assessing Enpark's arguments using this state law framework. The record before the Panel indicates that Enpark's arguments raised at least three issues the bankruptcy court could have considered under applicable New York law: (i) whether the Revenue Purchase Agreement was a disguised loan; (ii) if the Revenue Purchase Agreement was a disguised loan, whether it contained a criminally usurious interest rate which rendered the entire agreement void;[10] and (iii) whether Enpark's arguments regarding the Revenue Purchase Agreement provided a basis for invalidation of the Settlement Agreement under **New York law**.

***7** It is not this Panel's function to take any position regarding these questions, other than to conclude that the bankruptcy court's determination that it was restricted from considering them was erroneous. On remand, these issues are ripe for adjudication.

The concurrence believes that this decision does not go far enough in analyzing the question of the proper treatment of the Settlement Agreement on remand, and that the Panel may be faulted for having disposed of an issue that might be deemed to have been harmless error by the trial court. Respectfully, we take a different view.

First, we question the applicability of the harmless error doctrine to our disposition of this matter. The harmless error doctrine describes a means by which a reviewing court determines **not** to disturb a ruling by the trial court based on the immateriality of the trial court's putative error. And our decision **not** to invoke that doctrine here is hardly a matter for which this Panel may appropriately be critiqued, especially where the Panel has also determined that the trial court made a clearly erroneous finding of fact that compels remand in any event.

More fundamentally, with respect to the legal issue on which the concurrence is concerned, we do not believe that the trial court's erroneous determination that it was **prohibited even from considering** whether there was a basis in applicable non-bankruptcy law to question the enforceability of FundKite's claim, a determination that runs directly contra the express directive of § 502(b)(1), could ever be "harmless." Assessing the availability and applicability of legal arguments concerning the enforceability of the Settlement Agreement presents a different question, and one that has not yet even been addressed.

For this reason, we do not agree that the decision leaves a necessary aspect of this issue unresolved. In our view, the issue of whether the trial court may look past the Settlement Agreement is "gating," in the sense that, as the trial court determined, there is a well-acknowledged doctrine that when parties settle a dispute, a court should normally give effect to their arrangement, and accord that arrangement the finality to

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which the parties agreed. *See Stein*, *supra*, 130 A.D.3d at 605. And that gating issue should be raised, argued, and disposed of by the trial court consistent with the dictates of § 502(b)(1) and applicable non-bankruptcy law.

Thus, while we acknowledge that the cases referenced in the concurrence provide one potential basis for the bankruptcy court to examine the enforceability of the Settlement Agreement, any such determination is for the trial court to decide after the parties have had an opportunity to raise the issue, cite relevant authority, and fully argue the matter to that court. It is not for this court to decide that issue prior to the presentation of arguments to the trial court, to define the parameters of such presentation, or to indicate which cases would be most relevant to the trial court's determinations.

We acknowledge, and applaud, the statement at the conclusion of the concurrence that it does not purport to decide the issue of whether the trial court **should** look past the Settlement Agreement. But we are concerned that that statement is difficult to square with the approach adopted in the concurrence. The concurrence expends several pages citing and providing detailed analysis of the holdings and import of numerous cases under New York law on one side of this subject; it would be difficult for a reader not to conclude that the concurrence is essentially opining not only on the proper scope of the inquiry, but also necessarily, on the "right" answer to the underlying question, and dictating that answer to the trial court. For the reasons previously stated, we believe that that exercise is inconsistent with the proper role of this appellate Panel, and is an activity in which this court should not engage.

CONCLUSION

***8** For the reasons set forth above, we VACATE the bankruptcy court's ruling and REMAND this matter for further proceedings consistent with this decision.

Concurrence by Judge Pearson

PEARSON, Bankruptcy Judge, concurring:
I generally concur with the disposition of this matter and the preceding opinion. I write separately because I believe the analysis needs to go further.

The majority asserts that it is sufficient to vacate based on our decision regarding a "gating" issue, without any examination of whether that "gating" issue could potentially make a difference to the outcome of the case. Based on the harmless error doctrine, I do not agree. If there are no non-frivolous arguments that would make Enpark's position tenable, Enpark would not be harmed by the trial court's failure to consider its arguments. This court does not act on errors unless those errors impact the rights of the parties. *Van Zandt v. Mbunda (In re Mbunda)*, 484 B.R. 344, 355 (9th Cir. BAP 2012) ("Generally speaking, we ignore harmless error"); *Litton Loan Servicing, LP v. Garvida (In re Garvida)*, 347 B.R. 697, 704 (9th Cir. BAP 2006) (refusing to reverse "for reasons that do not affect the substantial rights of parties") (citing, *inter alia*, 28 U.S.C. § 2111). Before vacating the bankruptcy court's decision, we must determine whether the bankruptcy court's decision to consider only the Settlement Agreement and general law favoring settlement agreements, and not Enpark's argument that that the Revenue Purchase Agreement is criminally usurious,[11] may have impacted Enpark's rights.

***9** Under New York law, the enforceability of a settlement agreement can be impacted by the nature of the underlying agreement. In *Denburg v. Parker Chapin Flattau & Klimpl*, 624 N.E.2d 995 (1993), the New York Court of Appeals (New York's highest court) considered whether a settlement agreement was unenforceable when the initial agreement underlying the dispute was itself unenforceable as against public policy. *Denburg* involved a dispute between a law firm and one of its former partners. The firm's partnership agreement provided that a withdrawing partner would receive certain payments, but only if he did not work for the firm's clients over the next two years after withdrawing. The Court of Appeals held that this anticompetitive term of the partnership agreement violated New York public policy and was unenforceable. *Id.* at 1000. This did not end the Court of Appeals' inquiry, however, because the firm and the former partner had also entered into a settlement agreement. The Court of Appeals also had to decide whether the settlement agreement—which arose from the dispute over the contract terms that violated public policy—was enforceable.

In making that decision, the Court of Appeals first noted the strong public policy favoring enforcement of settlement agreements. But that public policy was not dispositive. The Court of Appeals acknowledged the former partner's argument that, if a settlement agreement of a dispute over an illegal contract was enforceable, the parties could by private agreement waive the illegality and evade the prohibitions

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against the original contract. *Id.* at 1001. The Court of Appeals then stated the rule in New York as follows: "While some bargains are so offensive to society that courts will not entertain the action—essentially leaving the parties where they are (*see, e.g., McConnell v Commonwealth Pictures Corp.*, 7 NY2d 465, 467 [involving commercial bribery]; *Flegenheimer v Brogan*, 284 NY 268, 272-273 [involving fraud])—in other cases an illegal agreement is not so repugnant and may be enforced (*see, Lloyd Capital Corp. v Pat Henchar, Inc.*, 80 NY2d 124, 127-128 [involving a federal regulatory violation that did not make a contract unenforceable under federal law]). It is all a matter of degree." *Id*.

The Court of Appeals noted that the provision in the law firm's partnership agreement was not per se illegal, but its enforceability was dependent upon facts and circumstances, and thus unlike situations involving commercial bribery or fraud. Therefore, the Court of Appeals concluded that the settlement agreement resolving the dispute over the anticompetitive terms of the partnership agreement could be enforced.

In addition to the rule in *Denburg*, there is a long history of cases where New York courts have refused to enforce settlement agreements that either include terms that are void in violation of New York law, or that perpetuate the enforcement of an underlying illegal contract. In *Drucker v. Mauro*, 30 A.D.3d 37(App. Div. 2006), a landlord and a tenant entered into a lease that incorporated a settlement over disputed items. The settlement terms in the lease were not consistent with New York's Rent Stabilization Law. Lease provisions violating that law are void, not merely voidable. The court refused to enforce the settlement.

In *Baksi v. Wallman*, 271 A.D. 422(App. Div. 1946), *aff'd*, 74 N.E.2d 172 (1947), a professional boxer entered into a management agreement with two of his managers. The management agreement was illegal and unenforceable because it violated New York's boxing laws. The two managers had stipulated to a settlement between themselves. The New York courts held that the stipulation of settlement could not be enforced without enforcing the illegal underlying contract, and that therefore, the settlement also was unenforceable. *Id.* at 426.

There is also a line of authority in New York that any new agreement that is made for the purpose of carrying out any of the unexecuted provisions of a previously illegal contract is tainted by the same illegality and void. *Boyd v. Boyd*, 130 A.D. 161 (App. Div. 1909); *Coffey v. Burke*, 132 A.D. 128 (App. Div. 1909); *Gray v. Hook*, 4 N.Y. 449, 459-60 (1851) ("When the contract grows immediately out of and is connected with an illegal or immoral act, a court of justice will not lend its aid to enforce it; and if the contract be in *part only* connected with the illegal transaction, and grows immediately out of it, though it be in fact a new contract, it is equally tainted by the illegality of the transaction from which it sprung.") (emphasis in original).

***10** If Enpark is correct that the Revenue Purchase Agreement is criminally usurious, then, depending on how this New York law is applied to the context of a criminally usurious agreement, it is possible that the Settlement Agreement may also be unenforceable under New York law.

Enpark's substantial rights were impacted when the bankruptcy court did not consider Enpark's arguments that Revenue Purchase Agreement was criminally usurious. We must vacate so the bankruptcy court can consider those arguments.

To be clear, a determination that Enpark's rights were affected because the bankruptcy court did not consider its arguments is not the same thing as a determination that Enpark's arguments are correct. The discussion of the case law above is not intended to dictate a "right" answer, but instead to show that there is a non-frivolous basis why Enpark's arguments about the allegedly-criminally usurious nature of the Revenue Purchase Agreement could matter to evaluation of the Settlement Agreement and the outcome of this case. This court need not decide, and is not deciding, whether the Revenue Purchase Agreement is criminally usurious or whether the Settlement Agreement is enforceable under New York law. On remand, Enpark is entitled to make its arguments, and FundKite is entitled to refute those arguments. We leave the ultimate merits for the bankruptcy court to determine.

All Citations

Not Reported in B.R. Rptr., 2024 WL 4328581

Footnotes

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1 Hon. Teresa H. Pearson, United States Bankruptcy Judge for the District of Oregon, sitting by designation.

* This disposition is not appropriate for publication. Although it may be cited for whatever persuasive value it may have, *see* Fed. R. App. P. 32.1, it has no precedential value, *see* 9th Cir. BAP Rule 8024-1.

2 Unless specified otherwise, all chapter and section references are to the Bankruptcy Code, 11 U.S.C. §§ 101–1532, "Rule" references are to the Federal Rules of Bankruptcy Procedure, and "Civil Rule" references are to the Federal Rules of Civil Procedure.

3 We have taken judicial notice of the bankruptcy court docket and various documents filed through the electronic docketing system. *See O'Rourke v. Seaboard Sur. Co. (In re E.R. Fegert, Inc.)*, 887 F.2d 955, 957-58 (9th Cir. 1989); *Atwood v. Chase Manhattan Mortg. Co. (In re Atwood)*, 293 B.R. 227, 233 n.9 (9th Cir. BAP 2003).

4 Nevada's Local Rule 1001(b)(1) automatically refers all bankruptcy cases in the District of Nevada to the bankruptcy court.

5 The Rules require claimants filing a proof of claim to, among other things, provide a copy of the writing on which the claim is based as well as evidence of perfection of any security interest the claimant asserts. Rule 3001(c)(1), (d). A proof of claim filed in accordance with the Rules constitutes prima facie evidence of the validity and amount of the claim. Rule 3001(f). Here, the bankruptcy court correctly held, and the parties do not dispute, that FundKite initially satisfied Rule 3001 by furnishing documentation adequate to serve as prima facie evidence of the validity and amount of the claim, i.e., the Revenue Purchase Agreement and the Settlement Agreement.

6 If the Settlement Agreement were an executory contract, this type of provision would be an unenforceable ipso facto clause under 11 U.S.C. § 365(e)(1). However, settlement agreements are not always executory contracts. *See Svenhard's Swedish Bakery v. U.S. Bakery (In re Svenhard's Swedish Bakery)*, 653 B.R. 471, 477 (9th Cir. BAP 2023). The effect of paragraph 9 is a matter the bankruptcy court should consider on remand.

7 The Panel further notes that the Settlement Agreement also contained fairly broad mutual releases of claims that FundKite asserts resolve any claim against it pertaining to the Revenue Purchase Agreement. The bankruptcy court referred to these releases at the conclusion of its oral ruling as further support for the proposition that the Settlement Agreement, and the Settlement Agreement alone, governed the parties' legal relations, and fully supported FundKite's claim.

However, the Panel also notes the broad and unqualified language of paragraph 9 of the Settlement Agreement, which, read plainly, indicates that if a debtor party filed bankruptcy, the Settlement Agreement would not be effective and the parties would essentially go back to square one. This outcome would presumably not include the option for either party to retain the benefit of the releases—but the parties can argue that point on remand.

Further, as referred to in section B of this Memorandum Decision, should the bankruptcy court on remand determine that, in light of the nature of the underlying transaction that gave rise to the Settlement Agreement, that agreement would not be enforceable under New York law, there would be no reason to enforce a release contained in such an unenforceable agreement.

8 The parties also cite and discuss cases holding that agreements waiving the benefits and protections of the Bankruptcy Code are void. *Continental Ins. Co. v. Thorpe Insulation Co. (In re Thorpe Insulation Co.)*, 671 F.3d 1011 (9th Cir. 2012); *Bank of China v. Huang (In re Huang)*, 275 F.3d 1173 (9th Cir. 2002); *Hayhoe v. Cole (In re Cole)*, 226 B.R. 647 (9th Cir. BAP 1998); *In re Pease*, 195 B.R. 431 (Bankr. D. Neb. 1996). The bankruptcy court correctly held these cases were irrelevant.

9 There is no dispute in this case that the Settlement Agreement meets the basic legal requirements in New York for a settlement to be an effective contract: it is in writing, signed by both parties, and includes material terms and a manifestation of mutual intent. N.Y. Civil Practice Laws and Rules, § 2104 (McKinney 2024); *Forcelli v. Gelco Corp.*, 972 N.Y.S. 2d 570, 573 (App. Div. 2013).

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10 Enpark provided ample law regarding these first two questions in its briefing before the bankruptcy court, including a decision involving a very similar contract that FundKite had with another borrower. *AKF, INC. d/b/a FundKite v. Western Foot & Ankle Center*, 632 F.Supp.3d 66 (E.D.N.Y. 2022).

11 Enpark argued that contracts to purchase future receivables are loans subject to usury laws and unenforceable, citing *Funding Metrics, LLC v. NRO Edgartown, LLC*, 2019 WL 4376780, 2019 N.Y. Slip. Op. 32651 (N.Y. Sup. Ct. Aug. 28, 2019); *GMI Grp., Inc. v. Unique Funding Sols., LLC*, 606 B.R. 467, 489 (Bankr. N.D. Ga. 2019) (applying New York law); *QFC, LLC v. Iron Centurian, LLC*, 2017 WL 2989222, 2017 N.Y. Slip. Op. 31438 (N.Y. Sup. Ct. July 5, 2017), *rev'd*, 179 A.D.3d 1110 (2020); *Merch. Funding Servs., LLC v. Volunteer Pharmacy, Inc.*, 55 Misc. 3d 316 (N.Y. Sup. Ct. 2016), *rev'd*, 179 A.D.3d 1051 (2020); *Pearl Capital Rivis Ventures, LLC v. RDN Constr., Inc.*, 54 Misc. 3d 470, (N.Y. Sup. Ct. 2016); *see also Funding Metrics, LLC v. D&V Hosp., Inc.*, 62 Misc. 3d 966 (N.Y. Sup. Ct. 2019), *rev'd*, 197 A.D.3d 1150 (2021). Enpark set forth the elements of criminal usury under New York law, and explained why, under the facts of this case, Enpark believed the Revenue Purchase Agreement was criminally usurious. Enpark also pointed out that, under New York law, criminally usurious loans are void and unenforceable, citing *AKF, Inc. v. Western Foot & Ankle Center*, 632 F.Supp.3d 66, 83 (E.D.N.Y. 2022), *vacated* (June 14, 2024). The New York Court of Appeals has ruled that a criminally usurious contract is void ab initio and unenforceable. *Adar Bays, LLC v. GeneSYS ID, Inc.*, 179 N.E.3d 612, 614-21 (2021). FundKite disputes that the Revenue Purchase Agreement is criminally usurious, asserting it is not a loan and that Enpark released all its defenses.

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