

Capstone Bus. Funding, LLC v Shames Constr. Co., Ltd.
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February 17, 2021
Supreme Court, New York County
Docket Number: 651801/2019
Judge: Melissa A. Crane
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SUPREME COURT OF THE STATE OF NEW YORK — NEW YORK COUNTY

PRESENT: MELISSA A. CRANE
Justice

PART 15

Capstone Business Funding, LLC

INDEX NO. 651801/2019

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DECISION AND ORDER

Shames Construction Company, Ltd.

Melissa A. Crane, JSC

This case presents a difficult, but narrow, question: Do estoppel certificates governed by New York law stand on their own, when the underlying transaction to which they apply is void, as opposed to voidable, in California, but would be perfectly legal in New York?

BACKGROUND

The underlying facts are not in dispute. Shames Construction Company, Ltd. (Shames) was the general contractor on a construction project at a mall in California. Shames hired MEP Nationwide, LLC (MEP) as its plumbing subcontractor pursuant to a June 25, 2018 subcontract. On July 25, 2018, MEP assigned its rights to payment for its work on the project to Capstone Business Funding, LLC (Capstone) in exchange for a loan against account receivables. Then, whenever MEP sent an invoice, it would advise Shames to pay Capstone.

In addition, Capstone directly sent Shames an “Estoppel Letter” for each invoice. In each Estoppel Letter, Capstone asked Shames’ accountants to acknowledge that there was no defense to payment with respect to the MEP invoice listed on top of the letter, in that the amount was:

“correct, due and owing by us; that the work and/or merchandise has been ordered from, and completed by the captioned client and accepted by us. Additionally, there will be no claims, setoffs, or defenses beyond 20%, of said invoice amount(s); that there will be no claims of any nature against the funds paid. Neither Capstone Business Funding, LLC nor its agents have made any representation except as herein set forth. This estoppel is not subject to modification. New York law, jurisdiction and venue shall apply hereto.”

Shames signed all the Estoppel Letters and paid Capstone for the first three MEP invoices.

It turns out MEP did not have a license to perform plumbing work in California. Meanwhile, California has very strict laws that forbid a subcontractor from collecting for any work performed without a license:

- (a) Except as provided in subdivision (e), no person engaged in the business or acting in the capacity of a contractor, may bring or maintain any action, or recover

in law or equity in any action, in any court of this state for the collection of compensation for the performance of any act or contract where a license is required by this chapter without alleging that he or she was a duly licensed contractor at all times during the performance of that act or contract regardless of the merits of the cause of action brought by the person, except that this prohibition shall not apply to contractors who are each individually licensed under this chapter but who fail to comply with Section 7029.

(b) Except as provided in subdivision (e), a person who utilizes the services of an unlicensed contractor may bring an action in any court of competent jurisdiction in this state to recover all compensation paid to the unlicensed contractor for performance of any act or contract.

(c) A security interest taken to secure any payment for the performance of any act or contract for which a license is required by this chapter is unenforceable if the person performing the act or contract was not a duly licensed contractor at all times during the performance of the act or contract.

(Cal. Bus. & Prof. Code § 7031).

“The purpose of the [California] licensing law is to protect the public from incompetence and dishonesty in those who provide building and construction services. The licensing requirements provide minimal assurance that all persons offering such services in California have the requisite skill and character, understand applicable local laws and codes, and know the rudiments of administering a contracting business” (*Montgomery Sansome LP v. Rezai*, 204 Cal. App. 4th 786, 793–94, 139 Cal. Rptr. 3d 181, 187 [2012]). The paramount public safety concern behind the licensing requirement in California’s construction industry is understandable, given the state’s propensity for mudslides, fires and earthquakes. New York has a similar rule, but only for residential projects (see *Metrobuild Assocs., Inc. v. Nahoum*, 51 A.D.3d 555, 556 [1st Dep’t 2008]; *Forman Constr., Inc. v. P.D.F. Constr.*, 175 A.D.3d 1491, 1492, 109 N.Y.S.3d 453, 454 [2nd Dep’t 2019]). The project in California was a commercial project and therefore ran afoul of California law, but not New York’s.

Shames fired MEP at least in part due to its lack of license. Shames sued in California state court for a declaration that it owed nothing and for MEP to disgorge the payments Shames had made to it. MEP defaulted. The California court, relying on California’s strict preclusion of payment for unlicensed contractors, granted judgment to Shames (See EDOC 88, Exhibit F to the Affidavit of Carolyn Shames, sworn to May 28, 2020). The court found that MEP was “not licensed at the time it conducted work under its Agreement with Shames” and therefore “collection of compensation for the performance under the Agreement with Shames is barred pursuant to Bus. & Prof. Code § 7031” (id).

When Shames did not pay the amounts on the remaining invoices to Capstone, Capstone sued Shames in New York state court on the Estoppel Certificates. Now Shames has moved for summary judgment and Capstone has cross moved for summary judgment.

DISCUSSION

I. Applicability of New York’s Uniform Commercial Code

It is unquestionable that New York law governs the Estoppel Certificates. Under New York law, "an agreement by the parties that the contract can be assigned free of any defenses which an account-debtor may have against the assignor is enforceable by a good-faith, for value

assignee against ordinary defenses, not including fraud, duress, or the like" (*Reliastar Life Ins. Co. of New York v Home Depot USA, Inc.*, 570 F3d 513, 517 [2d Cir. 2009]; see also NY UCC 9-403[b]).

NY UCC § 9-403, entitled "Agreement Not to Assert Defenses Against Assignee" would, by its title, seem to apply to Capstone and Shames' relationship. However, the statute is hardly a model of clarity. The statute initially states:

(b) Agreement not to assert claim or defense. Except as otherwise provided in this section, an agreement between an account debtor and an assignor not to assert against an assignee any claim or defense that the account debtor may have against the assignor is enforceable by an assignee that takes an assignment:

(1) for value;

(2) in good faith;

(3) without notice of a claim of a property or possessory right to the property assigned; and

(4) without notice of:

(A) a defense of the obligor based on (i) infancy of the obligor to the extent it is a defense to a simple contract, (ii) duress, lack of legal capacity, **or illegality of the transaction** which, under other law, nullifies the obligation of the obligor. . .

(emphasis added)

Capstone contends that this part of § 9-403 addresses a contract that would have to be between MEP, the assignor, and Shames, the account debtor, not to assert defenses against Capstone, rather than a representation from directly from Shames to Capstone, in an Estoppel Certificate, that no defenses exist. Instead, Capstone points out, there is a carve out in § 9-403(f) that leaves a separate agreement between an account debtor and an assignee like Capstone up to other law:

(f) Other laws not displaced. Except as otherwise provided in subsection (d), this section does not displace law other than this article which gives effect to an agreement by an account debtor not to assert a claim or defense against an assignee.

Official Comment 4 to section § 9-403 elaborates:

Nor does this section displace other law with respect to waivers of potential future claims and defenses that are the subject of an agreement between the account debtor and the assignee (emphasis in original).

However, Capstone did not account for § 9-404 governing "Rights Acquired By Assignee; Claims and Defenses Against Assignee" and Official Note 2 to that section stating:

Of course an account debtor [i.e. Shames] may waive its right to assert defenses or claims against an assignee [i.e. Capstone] **under § 9-403** or other applicable law (emphasis added).

Thus, it would appear that § 9-403's restrictions on waiver of defenses (like illegality) does apply to Capstone and Shames' Estoppel Letters through § 9-404. Moreover, because § 9-403 and § 9-404 expressly do not displace "other law," Capstone would still be subject to NY UCC § 3-305 governing holders in due course. That section states:

To the extent that a holder is a holder in due course he takes the instrument free from:

- (1) all claims to it on the part of any person; and
- (2) all defenses of any party to the instrument with whom the holder has not dealt except
 - (a) infancy, to the extent that it is a defense to a simple contract; and
 - (b) such other incapacity, or duress, ***or illegality of the transaction, as renders the obligation of the party a nullity.*** (emphasis added).

Thus, "illegality of the transaction" can nullify a contractual obligation to a subsequent holder in due course. But, like section 4-903(f), the statute leaves "illegality" to local law as the official commentary to NY UCC § 3-305 explains:

Illegality is most frequently a matter of gambling or usury, but may arise in many other forms under a great variety of statutes. The statutes differ greatly in their provisions and the interpretations given them. They are primarily a matter of local concern and local policy. All such matters are therefore left to the local law. If under that law the effect of the duress or the illegality is to make the obligation entirely null and void, the defense may be asserted against a holder in due course. Otherwise it is cut off.

Accordingly, it would appear that: (1) New York's Uniform Commercial Code applies to the Estoppel Letters Capstone sent to Shames and (2) neither NY UCC § 3-305 nor § 9-403(f) is meant to override local law regarding what constitutes "illegality."

II. Local Law

It thus becomes important to determine, under New York law, what sort of "***illegality of the transaction which, under other law, nullifies the obligation of the obligor,***" can defeat a waiver of defenses in an estoppel certificate. Under New York law, an illegality defense "is available only if under applicable state law the effect of the illegality is to make the obligation entirely null and void; the defense is ineffective against a holder in due course if the illegality causes the contract to be merely voidable" (*Banker's Trust Co., v Litton Systems, Inc.* 599 F2d 488, 491 [2d Cir 1979] [bribery induced contract merely voidable]; *see also Nat'l Union Fire Ins. Co. of Pittsburgh, Pa., v Pachnanda*, 258 AD2d 256, 257 [1st Dep't 1999][violation of registration requirement in Section 5(c) of the Securities Act of 1933 rendered defendant guarantor's obligations voidable, not completely null and void, and therefore not illegal so as to deprive plaintiff of holder in due course status"]; *Wells Fargo Bank, N.A. v. BrooksAmerica Mortg. Corp.*, 419 F.3d 107 [2d Cir. 2005] [unenforceability is not enough to defeat a waiver of defenses in an estoppel certificate]; *but see Nationstar Mortg. LLC v. Hunte*, 2020 WL 5646141, at *3 [S.D.N.Y. Sept. 22, 2020] ["contract that does not come into force due to the failure of a condition precedent is void, not voidable" and therefore could not be ratified]).

In cases involving a usurious mortgage, under the concept of *estoppel in pais*, an "assignee's right of recovery does not depend upon the title or interest of his assignor, but upon the mortgagor's representation by his certificate or by his conduct that the mortgage is valid and existing" (*Hammelburger v Foursome Inn Corp.*, 54 NY2d 580, 587 (1981)). The policy behind this rule is to prevent one who has represented a transaction to be valid, from later "asserting that it is void, to the injury of those who have acted in reliance upon the representation" (*id.* at 587) "The conduct or certificate, must, however, have influenced the assignee to accept [the assigned

contract] to his injury." (*id* at 588; 79 NY2d 735, 742 [1992]; *cf. Quantum Corporate Funding Ltd. v LPG Assoc. Inc.*, 246 AD2d 320, 323-324 [1st Dep't 1998][having undertaken independent obligation to subcontractor's factor, general contractor could not assert lien law/trust fund claims of suppliers as a defense to payment]). However, neither *Quantum* nor *Hammelberger* dealt with UCC provisions that leave the determination of illegality to local law. Nor did either case deal with a contract a California court has rendered void.

In California, the contract between Shames and MEP is not merely voidable, it is void entirely and therefore can defeat an assignee's claim (*see Wilson v Steele*, 259 Cal Rptr 851, 857 (Cal App. 1989) (if loan was for construction, contract underlying negotiable instrument was void because contractor lacked a license and therefore holder of negotiable instrument would have no legitimate claim); *see also In re Abeinsa Holding Inc. et al*, 2019 WL 1400175 at *6 [D. Del. Bkr. March 26, 2019][same]; *Cf. Kedzie and 103rd Currency Exchange, Inc v Hodge*, 619 NE2d 732 (Ill. 1993) (disagreeing with California approach that merely void contract without statutory illegality defeats negotiable instrument that comes with it, but recognizing that unlicensed contractor results in a void contract in California).

III. Application of Local Law

Given that California law renders the contract between Shames and MEP void, rather than voidable, Capstone cannot be a holder in due course under NY UCC § 3-305; or hold a valid assignment under NY UCC § 9-403. *In re Abeinsa Holding Inc. et al*, 2019 WL 1400175 at *6 [D. Del. Bkr. March 26, 2019]), a case Shames cites, is directly on point. Using a holder in due course analysis, the Delaware Bankruptcy court held, in spite of language in estoppel certificates, the factor could not recover. This was because the underlying transaction and contracts were void under Cal. Bus. & Prof. Code § 7031, the same California statute at issue in this case. The Delaware Bankruptcy court reasoned that the factoring agreement was an assignment, and, therefore, under UCC § 3-305(b), illegality was a defense. As the contract was illegal in California, the factor could not enforce the contract against the entity that took on the debts of the unlicensed California contractor. (*See Abeinsa* at *6). In affirming, the Federal District Court for the District of Delaware explained:

ATMGP's signature confirmed only that its payment of *the invoices* was not subject to an offset, back charge, or dispute. The condition precedent of that confirmation is that there were invoices to collect. To the extent the April letter created obligations on ATMGP's part or gave Crown rights to the payment of Synflex's invoices, those obligations and rights exist only insofar as Synflex had extant invoices. In this case, however, it is undisputed that the invoices Synflex issued to ATMGP were void as a matter of law. Thus, the Bankruptcy Court correctly concluded that it "d[id] not need to consider the validity of an alleged independent contract, as the claims [i.e., the invoices] underlying the contract are void (citation omitted).

(*In re Abeinsa Holding Inc.*, 2020 WL 6261632, at *3 [D. Del. Oct. 23, 2020]).

Here, the situation is exactly the same. Capstone, as assignee, only has a right to payment to the extent there are invoices. Shames' waiver of defenses that "there will be no claims, setoffs, or defenses beyond 20%, of said invoice amount(s)" refers only to the invoices. Thus, Capstone's rights under the Estoppel Letters rise and fall with the invoices. In this case, however, a California court has declared the invoices MEP issued

to Shames void as a matter of law (see EDOC 88). Thus, they no longer exist. As the invoices no longer exist, so too is Capstone's ability to collect on them.

Quantum Corporate Funding Ltd., v L.P.G. Assoc., 246 AD2d 320 [1st Dep't 1998], upon which Capstone relies, is distinguishable, because it does not involve a situation that the UCC specifically governs. *Quantum* instead dealt with the diversion of Trust Assets under Article 3-A of New York's Lien Law, not a contract made void by illegality under California law. Indeed, in another case upon which Capstone relies, *Reliastar*, in the specific context of UCC § 9-403, the court held that Home Depot could assert constructive eviction as a defense because "it is similar to the defenses of fraud and duress in that it goes to the very existence of the agreement, rather than the failure to perform in accordance with the terms of the agreement."

The equities also support this result. Given the natural disasters to which California is prone, California has more of a public safety interest in making sure unlicensed contractors do not reap any benefits, than New York does in upholding the Estoppel Letters between private companies. Moreover, Capstone is not without recourse as it can sue MEP. Indeed, Capstone is a secured creditor of MEP:

"To secure the representations and covenants made by Seller in this Agreement, but not the credit risk of the Account(s), Seller hereby grants to Purchaser a continuing security interest, and a priority lien in all personal property and fixtures in which Seller has an interest, now or hereafter existing or acquired, and wheresoever located, tangible or intangible. . ."

Finally, the assignment from MEP to Capstone occurred BEFORE Shames signed the Estoppel Letters, so it is unclear how Capstone relied on the Estoppel Letters to lend money to MEP in the first place.

Accordingly, it is

ORDERED THAT the court grants Shames' motion for summary judgment and denies Capstone's cross motion for summary judgment.

The clerk is directed to enter judgment dismissing this action with prejudice.

Dated: February 17, 2021
New York, New York



JSC