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Know When to Hold 'Em, Know When to Fold 'Em

The Differences Between a Loan and Merchant Cash Advance

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Some say merchant cash advances provide a creative solution to a small business's cash-flow problems. Others view them as a form of predatory lending, tantamount to fraudulent and usurious loans. Like many things, the truth is probably somewhere in between.

What Is a Merchant Cash Advance?

Merchant cash advances gained popularity following the Great Recession, but have existed for more than 20 years.[2] They are often marketed to small businesses that need working capital, but are more susceptible to disruptions in cash flows and may be unable to qualify for a loan.[3]

Generally, merchant cash advances provide an alternative to traditional financing. In exchange for an immediate advance of cash from the "purchaser," the business sells its future receivables (the equivalent of a payday advance loan for business).[4] The purchaser then performs regular reconciliations and withdraws an agreed sum from the merchant's account as the receivables are collected, typically daily. The reconciliation process sometimes allows the business to tie the amount of its payment to a percentage of receipts rather than being tethered to a fixed monthly payment.

Merchant Cash Advances in Bankruptcy

How you characterize a merchant cash advance transaction — either as a loan or a sale of receivables — impacts many aspects of a bankruptcy case. Most obviously, whether a transaction is a secured financing transaction or a sale of receivables impacts the determination of what is property of the bankruptcy estate. It can also shape the application and effect of the automatic stay or positions that parties take (or do not take) with respect to the use of cash collateral. The characterization of the transaction also influences the analysis of potential preferential transfer actions under § 547 of the Bankruptcy Code. It is also relevant in the claims-objection process, as the interest charged would often be usurious.

However, one should not underestimate the leverage created by uncertainty. In fact, merchant cash advance companies often do not file proofs of claim or otherwise participate in a bankruptcy case to avoid the consequences of a potentially adverse ruling.

State Law Determines Whether the Obligation Is a Loan or Sale of Receivables

How to characterize the transaction is a question of state law, although a choice-of-law determination is unnecessary unless it impacts the outcome.[5] Indeed, "[w]hen determining whether a transaction is a loan, substance — not form — controls."[6] The terminology used in the agreements is not dispositive.

In evaluating whether a transaction is a loan or a sale of receivables, courts generally engage in a flexible three-factor analysis. To analyze whether repayment of an obligation is absolute or contingent, courts consider "(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."[7] The ability for a merchant's payments to be adjusted based on a reconciliation is a hallmark of a true sale of the receivables and informs the second factor. If the amount of the monthly payment changes, the term of the agreement is not finite and will vary based on the fluctuations in the amount of the monthly payments.

The third factor addresses the risk of nonpayment by the accounts receivable debtor. In a true sale transaction, the purchaser bears the ultimate

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1 The views expressed in this article are solely those of the authors, and the statements made in the article should not be attributed to their firms or clients.

2 *Gecker v. LG Funding LLC (In re Hill)*, 589 B.R. 614, 618 (Bankr. N.D. Ill. 2018). One of the first published decisions about a merchant cash advance concept involved a restaurant that entered an advance meal sales agreement, pursuant to which it was advanced $22,000 in exchange for a portion of its future credit card receipts. *Ideas v. 999 Rest. Corp.*, No. 0602303/2006, 2007 WL 3234747 (N.Y. Sup. Ct. Oct. 12, 2007).

3 *Hill*, 589 B.R. at 618; *see also United Cap. Source, LLC v. Benisvy*, 18 N.Y.S.3d 582 (Sup. Ct. 2015).

4 Sadly, much like a payday advance loan, a business will sometimes obtain additional merchant cash advances to pay off the prior advances, initiating a vicious cycle from which the merchant cannot escape, given the high interest rates and charges associated with the merchant cash advance structure.

5 *Cap Call LLC v. Foster (In re Shoot the Moon LLC)*, 635 B.R. 797, 811-12 (Bankr. D. Mont. 2021).

6 *Adar Bays LLC v. GenSYS ID Inc.*, 179 N.E.3d 612, 621-22 (N.Y. 2021).

7 *LG Funding LLC v. United Senior Props. of Olathe LLC*, 122 N.Y.S.3d 309, 312 (N.Y. App. Div. 2020) (quoting *K9 Bytes Inc. v. Arch Cap. Funding LLC*, 57 N.Y.S.3d 625, 632 (Sup. Ct. 2017)).

risk of nonpayment, but where the merchant's obligation to repay is absolute, it is a loan. Likewise, contract provisions where insolvency or the filing of bankruptcy constitute a default resulting in the acceleration of the balance due, or the requirement of a confession of judgment, tend to indicate that the obligation to repay is absolute and suggest that the transaction should be characterized as a loan, rather than a true sale of receivables. Distilled to its essence, the primary feature distinguishing a loan from a cash advance is that a lender "is absolutely entitled to repayment under all circumstances."[8]

The tide seems to be turning on courts' willingness to strictly enforce merchant cash-advance agreements, with a recent growing trend toward recharacterizing the transaction as a loan. However, it remains to be seen whether these case law developments will chill the popularity of merchant cash advances or how the terms of such transactions will evolve in response.

Recent Case Law Developments

In June 2022, the U.S. District Court for the Southern District of New York analyzed the issue in the *Fleetwood Services LLC* decision.[9] In this case, the funding provider agreed to advance the merchant $100,000 in exchange for the merchant's future receivables until the sum of $149,900 was repaid by the merchant.[10] The agreement in *Fleetwood Services* included a reconciliation provision, but the funding provider also required the merchant and its principals to execute a security agreement and personal guaranty, a confession of judgment, and a separate agreement authorizing direct deposit and direct payment to the funder.[11] The purchased receivables were to be repaid from daily withdrawals from a designated account in the fixed amount of $1,399, which the agreement contended was 10 percent of the merchant's receipts.[12] In concluding that the transaction should be characterized as a loan, the court focused on the fact that there were "virtually no circumstances where, if the accounts receivable would not be sufficient to pay the Purchased Amounts, [the funding provider] would not be absolutely entitled to repayment."[13]

Another New York court also recently tackled the issue of evaluating whether a transaction is a loan or a purchase of future receivables.[14] In the *HI bar Capital* case, the agreement between the funding provider and merchant provided for the purchase of $472,500 of the merchant's receivables for $350,000.[15] The agreement also required a daily withdrawal of $4,725 until the amount advanced was fully repaid, and included guaranties and the grant of a lien upon the receivables.[16] In response to the merchant's arguments that the loan was usurious, the funding provider claimed that the transaction was a cash advance, rather than a loan, and argued that the inclusion of a reconciliation provision in the agreement established that the obligation was a true cash advance.[17]

Applying the three-factor analysis, the court focused on the reconciliation provision in the agreement. The provision was discretionary in that a reconciliation was triggered by the merchant's request. The court rejected the merchant's argument that the discretionary nature of the reconciliation provision rendered the term illusory and ultimately concluded that the agreement was not a loan.[18]

These recent New York decisions may influence bankruptcy law and issues, given that many merchant cash-advance agreements are governed by New York law and bankruptcy courts across the country often apply the same three-factor analysis to evaluate whether a transaction is a loan or a merchant cash advance. However, some bankruptcy courts consider additional factors, including the right to excess collection, whether the seller retains an option to repurchase the accounts, whether the purchaser can unilaterally alter the pricing terms, and the conduct of the parties.[19]

Other Bankruptcy Considerations

The characterization of the transaction can be a gating issue for a bankruptcy court's consideration of other state law claims, such as usury. Prior to seeking relief under chapter 11, the debtor in the *Shoot the Moon LLC* case operated restaurants in Idaho, Montana and Washington, and entered into several agreements purporting to be merchant cash advances.[20] There, the chapter 11 trustee challenged the nature of the transactions with the funding providers. In deciding that the transactions were loans, the bankruptcy court focused on the fact that the merchant agreements granted a broad security interest in all of the debtor's assets, rather than just the receivables, and that the documents referred to the merchant as a "debtor" rather than a "seller."[21] The court also noted that the debtor's principal had executed an absolute guaranty of the obligation, providing other recourse to the funder.[22] This characterization of the transaction as a loan allowed the bankruptcy court to consider whether the loans were usurious, and thus enforceable under applicable nonbankruptcy law.[23]

The characterization of cash-advance transactions is also relevant in the context of claims objections. For example, a debtor may object to a proof of claim filed by a creditor with whom the debtor had entered into a merchant cash advance agreement and may seek to recharacterize the transaction as a loan in order to argue that the interest charged is usurious.[24] This was the issue in the *GMI Group* case, where the bankruptcy court again applied the three-factor test to determine that the merchant cash advance agreement should be recharacterized as a loan.[25] Even though the agreement had a reconciliation provision and the filing of bankruptcy

8 *Id.*
9 *Fleetwood Servs. LLC v. Ram Cap. Funding LLC*, Case No. 20-cv-5120 (LJL), 2022 WL 1997207, at *8-10 (S.D.N.Y. June 6, 2022).
10 *Id.* at *2.
11 *Id.*
12 *Id.*
13 *Id.* at *13.
14 *HI bar Cap. LLC v. Parkway Dental Servs.*, 2022 N.Y. Slip. Op. 30989 (N.Y. Sup. Ct. 2022).
15 *Id.*
16 *Id.*
17 *Id.*
18 *Id.* at *2 (citing *IBIS Cap. Grp. LLC v. Four Paws Orlando LLC*, 2017 WL 1065071 (N.Y. Sup. Ct. 2017)).
19 *Cap Call LLC v. Foster (In re Shoot the Moon LLC)*, 635 B.R. 797, 813 (Bankr. D. Mont. 2021).
20 *Id.*
21 *Id.* at 814-15.
22 *Id.*
23 *Id.* at 820.
24 *GMI Grp. Inc. v. Unique Funding Solutions LLC (In re GMI Grp. Inc.)*, 606 B.R. 467 (N.D. Ga. 2019).
25 *Id.* at 484-85.

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did not require the debtor to repay the outstanding balance, the bankruptcy court concluded that the agreement was a disguised loan in violation of New York criminal usury law.[26] (Interestingly, the court noted that the three-factor test was "helpful" but not "dispositive."[27]) The agreement did not have a finite term for repayment, but more importantly, the bankruptcy court focused on the fact that the agreement required the debtor to maintain at least twice the amount of the daily payment in its account and that the debtor's failure to maintain such amounts was an event of default, triggering full unconditional liability and rendering the risk of nonpayment illusory.[28]

While whether a transaction is a loan or a true sale should always be considered and evaluated, sometimes the issue can prove to be a red herring. In the *Hill* case, a chapter 7 trustee filed a three-count complaint against a merchant cash advance funder seeking the avoidance and recovery of preferential transfers and constructively fraudulent transfers and disallowance of the creditor's claim.[29] The trustee contended that the transaction was a loan and not a true sale of future receivables, while the funding provider argued that it was not a creditor and the payments received from the debtor before the petition date were not on account of an antecedent debt.[30] The issue of whether the transaction was a loan or a true sale was not dispositive, as the bankruptcy court concluded that even though the transaction was not a loan, an antecedent debt still existed, as the funding provider had a right to repayment, which fell within the definition of "claim" under the Bankruptcy Code.[31]

Conclusion

As shown in the case law, the characterization of a merchant cash agreement as a loan or a true sale of receivables is far from an exact science, and the body of decisional law is continually evolving, shaped by both state courts and bankruptcy courts. Litigants should remember that courts will generally not elevate form over substance when evaluating a transaction, and experienced practitioners will take the time to carefully evaluate whether the parties need to call on the courts to resolve the issue and the benefits and consequences that flow from the determination of the issue. abi

26 *Id.* at 486-87.
27 *Id.*
28 *Id.* at 486.
29 *Gecker v. LG Funding LLC (In re Hill)*, 589 B.R. 614, 620 (Bankr. N.D. Ill. 2018).
30 *Id.* at 621.
31 *Id.* at 624.

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