Merchant Cash Advances: The Good, The Bad, and the Ugly

Hon. Jerry C. Oldshue, Jr.
Chief U.S. Bankruptcy Judge, Southern District of Alabama

The Allure of Merchant Cash Advances

Merchant Cash Advances (MCAs) are financial transactions which offer businesses a one time, lump-sum cash payment (advance) to be paid back over time from a stream of payments based on a percentage of future sales or receivables.[1] MCAs have been around in some form or another for nearly two decades.[2] They are often attractive to businesses which are strapped for cash but cannot qualify for more traditional lending. To garner customers, MCA lenders tout benefits such as a streamlined application process, relaxed underwriting, high approval rates, few use restrictions, and quick cash without requirements of equity or collateral (other than a share of sales or receivables).[3] There are more than 33 million small businesses employing more than 60 million people in the United States. Rising interest rates and tightening credit markets have made it more challenging for those businesses to access capital. Consequently, the MCA market has increased substantially over the past five years and is expected to continue to grow.[4] It only takes a quick google search to find an expansive list of MCA lenders promising, "debt relief", "financial freedom", and "assistance in restructuring business debt".

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[1] *See* Mark K. Singla, *MCAs: Lifesavers, or Debt Traps*?, Am. Bankr. Inst. J., November 2023 at 36 (explaining that an advance is multiplied by a factor rate to calculate the payback amount, factor rates typically range between 1.1 and 1.5 based on the financial strength and risk of the business, the holdback rate may be structured as a percentage of sales, often ranging between 10-20 percent or a fixed dollar amount, repayment periods can range widely, though 12- to 18-month periods are common, and remittances are usually daily or weekly.

[2] See *Ideas v. 999 Restaurant Corp.*, 2007 WL 3234747 (N.Y. Sup 2007).

[3] Merchant Cash Advance Industry Statistics, https://altline.sobanco.com/merchant-cash-advance-industry-statistics/

[4] Singla, supra note 1, noting that the global MCA market size is expected to grow 22 percent annually.

Potential Pitfalls of Merchant Cash Advances

Although business owners may initially see Merchant Cash Advance agreements as the solution to their cash flow problems, they may not fully comprehend the ramifications of entering into such arrangements. MCA documents can be murky, making it difficult for a small business, without the benefit of legal counsel, to fully appreciate the risks.[5] As part of the transaction, MCA lenders may require a security agreement, personal guaranty, and even a confession of judgment.[6] MCA transactions often drastically discount the value of future receivables, so much so that if it were considered a secured loan, it would easily run afoul of prohibitions on usury.[7] Factoring amounts can equate to annual percentage rates ranging from 50 to 200 percent, or more.[8] MCAs generally have a short repayment term and require automatic withdrawals from the businesses bank account or credit card receipts on a daily or weekly frequency. This can exacerbate business cash flow issues leading to a debt snowball with businesses stacking multiple MCA transactions in an attempt to stay afloat. Not surprisingly, some businesses sinking further in debt with onerous MCA arrangements may seek the protection of bankruptcy court.

Interplay of Bankruptcy and Merchant Cash Advances

Whether bankruptcy may ultimately provide an MCA burdened business debtor the fresh start they hope for often depends on the characterization of the merchant cash advance agreement(s). Such determination is a threshold issue because whether an MCA is a loan or a sale

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[5] *Id.*

[6] *See Fleetwood Servs., LLC v. Ram Cap. Funding, LLC*, No. 20-CV-5120 (LJL), 2022 WL 1997207 (S.D.N.Y. June 6, 2022.

[7] Scott J. Bogucki, *MCA Transactions: True Sale or Disguised Loan?*, Am. Bankr. Inst. J., December 2022.

[8] *Id.*

can impact other aspects of the case including: the debtor's eligibility,[9] delineation of property of the estate,[10] applicability of the automatic stay, potential state-law claims and defenses, possible preferential transfer actions[11], lien validity and priority, cash collateral motions, and the overall prospects for a chapter 11 debtor to reorganize.

As Merchant Cash Advances are hybrid financing arrangements, determining whether such transactions should be treated as loans or sales in bankruptcy is not an easy feat.[12] Neither the UCC nor the Bankruptcy Code delineate when a transaction should be classified as a sale versus a loan.[13] Thus, inquiry into whether a transaction is a loan or a sale typically requires a fact-intensive determination based on the totality of circumstances.[14] Courts grappling with this issue have considered a number of factors in their analysis. The table on the following page provides factors which courts have evaluated and examples of their application.[15]

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[9] See *In re Heart Heating & Cooling, LLC*, No. BR 23-13019 TBM, 2024 WL 1228370 (Bankr. D. Colo. Mar. 21, 2024)(finding that Merchant Cash Advance debt must be counted toward the statutory debt cap).

[10] See In re *R&J Pizza Corp.*, No. 14-43066-CEC, 2014 WL 12973408 (Bankr. E.D.N.Y. Oct. 14, 2014).

[11] See *In re A Goodnight Sleepstore, Inc.*, No. 17-03274-5-JNC, 2019 WL 342577, at 6 (Bankr. E.D.N.C. Jan. 25, 2019)(wherein the bankruptcy Trustee's allegations that daily ACH drafts taken by MCA lender constituted preferential transfers survived Defendant's Motion for Summary Judgment).

[12] See *In re Shoot The Moon*, LLC, 635 B.R. 797, 812–13 (Bankr. D. Mont. 2021)(noting that, 'The shared aspects are reflected in the commentary to Article 9 of the Uniform Commercial Code where the drafters recognize that "[i]n many commercial financing transactions the distinction is blurred.' 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. 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.")

[13] See *U.C.C. §9-109* and official comments.

[14] *In re Shoot the Moon* at 813.

[15] The information set forth in this Chart was derived from the following sources: *Fleetwood Servs., LLC v. Ram Cap. Funding, LLC*, No. 20-CV-5120 (LJL), 2022 WL 1997207 (S.D.N.Y. June 6, 2022);*In re Shoot The Moon, LLC*, 635 B.R. 797 (Bankr. D. Mont. 2021); *In re GMI Grp., Inc.*, No. 19-52577-PMB, 2019 WL 3774117, at 1 (Bankr. N.D. Ga. Aug. 9, 2019) *In re Steele*, No. 17-03844-5-JNC, 2019 WL 3756368 (Bankr. E.D.N.C. Aug. 8, 2019); In re *R&J Pizza Corp.*, No. 14-43066-CEC, 2014 WL 12973408 (Bankr. E.D.N.Y. Oct. 14, 2014); Singla, supra note 1; Kathleen L. DiSanto & Luis E. Rivera II, *Know When to Hold 'Em, Know When to Fold 'Em the Differences Between A Loan and Merchant Cash Advance,* Am. Bankr. Inst. J., January 2023; Bogucki, supra note 7; Kara J. Bruce, *The Murky Process of Characterizing Merchant Cash Advance Agreements*,42 No. 4 Bankruptcy Law Letter NL 1, April 2022.

Factors For Evaluating if MCA is a Sale or a Loan:	*Specific Facts that May Weigh in the Determination:*
Whether The Risk Of Loss Is Allocated To The MCA Lender (Buyer) Or The Business (Seller).	In a sale, post-closing, the Buyer, takes on the risk of loss; while in a secured loan, the lender's contractual entitlement to payment generally is not dependent on the status of the property. Thus, when the risk of loss remains with the Seller, such as agreements that contain collectability guarantees, chargebacks, and indemnification provisions, courts may view it more akin to a secured loan.
Whether The Seller Retains Rights in the Receivables.	Transactions in which the Seller maintains residual rights in the property, such as the right to retain collections over a determined amount or the right to repurchase the receivables, are more likely to be recharacterized as secured loans.
Whether There Was An Independent Investigation By The Buyer Of The Account Debtor(s).	The extent to which the Buyer investigates the collectability of the account receivables to be purchased, prior to the transaction has been considered in some cases. One would expect that upon a true sale, the Buyer would want to be assured of the creditworthiness of the underlying account debtors/customers. Hence, if the Buyer does not perform any due diligence in that regard, it can support finding the transaction should be characterized as a loan.
Whether The Seller Continues To Service The Accounts And Commingles Receipts With Its Operating Funds.	In a typical sale transaction the Buyer takes control of the asset and the obligations associated therewith. Thus, when a Seller continues to service the account or commingles funds, it can weigh in favor of a finding that the transaction is more like a loan.
Whether The Buyer Can Unilaterally Alter The Pricing Terms Of The Underlying Asset.	When a Seller Retains the right to modify or compromise the terms of the accounts, which were purportedly sold, that control can weigh in favor of finding the transaction to be a loan rather than a true sale.
The Language Of The Agreement And The Parties' Conduct.	Courts tend to differ greatly on the weight afforded to this factor. When the documents refer to a transaction as a sale but contain debtor/creditor type language akin to terminology typically found in secured loan transactions, that may weigh in favor of finding the transaction should be treated as a loan. Courts may look past self-serving proclamations such as "This Is Not a Loan" when the substance of the underlying transaction reflects otherwise.

Illustrative Cases

I. In re Shoot the Moon; MCA = Loan

In the case of *In re Shoot the Moon, LLC,* the United States Bankruptcy Court for the District of Montana found that the Chapter 11 Debtor's pre-petition Merchant Cash Advance was a disguised loan, not a sale transaction.[16] Shoot the Moon, LLC ("STM"), consisted of 19 LLCs, which were in the business of operating sixteen restaurants throughout three states. Financial difficulties eventually led STM to seek financing from merchant cash advance companies. As is typical in these transactions, the MCA lender provided STM with quick cash to continue its operations in exchange for a portion of future receivables which were deducted by daily ACH bank account debits. A Chapter 11 Trustee was appointed in the STM Chapter 11, who also served as the Trustee of the liquidating trust under the confirmed plan. The Trustee sold substantially all the assets of the business under §363 and also sought turnover of approximately $228,449.93 held by the entity which processed payments of the Debtor's receivables. The MCA lender filed a proof of claim and asserted conversion of the receivables pursuant to its alleged ownership therein. The Montana Bankruptcy Court noted entitlement to the funds hinged on whether the MCA transaction was classified as a loan or a sale.

In its analysis, the Court explained that whether the transaction should be treated as a loan or a sale required an intensive evaluation of the above factors based on the totality of the circumstances and concluded that the MCA transactions were substantially similar to a loan.[17] The

[16] *In re Shoot The Moon, LLC,* 635 B.R. 797 (Bankr. D. Mont. 2021).
[17] *Id.* at 819.

Court explained that allocation of the risk overlays and unites the determining factors and found the following facts were indicative of a loan transaction:

1. The documents were significantly broader than those associated with a sale and much more akin to a loan. For instance, the MCA agreement purported to secure payment and performance obligations 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."[18] Thus, the Court noted that outside the context of a secured loan, there is no reason why the MCA lender should receive and perfect security interests in assorted assets other than the purchased receivables.
2. The documents gave the MCA lender rights and recourse against property in addition to the overbroad collateral package. This included a broad personal guaranty by the Debtor's principal, an affidavit of confession of judgment by the Debtor and the personal guarantor in a fixed sum equal to the amount to be paid to the MCA lender plus legal fees and interest. It also provided various other protections and extraordinary rights, including a broad power of attorney and the MCA Lender's ability to enforce security interest in collateral (which included much more than just the receivables) and even potentially take over the restaurants.[19]
3. The parties course of dealing reflected a debtor-creditor relationship. For instance, the Debtor commingled receivables (that the MCA Lender purportedly bought) with other

[18] *Id.* at 814, 815.
[19] *Id.* at 815.

funds and the parties "stacked" or "rolled" funds from one transaction to the next (satisfying the outstanding obligations and effectively refinancing the earlier transactions) which the Court concluded only made sense in the context of a loan.[20]

The *In re Moon* Court also acknowledged that the evidence was not entirely one-sided. For example, the MCA documents did not allow the Debtor to repurchase the receivables, did not permit the Debtor to alter the pricing terms, and contained language indicating that the transaction was "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."[21] Even so, the Court found that such language was not convincing and stated that "[s]imply calling transactions 'sales' does not make them so" because labels cannot change the true nature of the underlying transactions" and "the countervailing evidence reveals that the term "sale" in the agreements is nothing more than a conclusory and self-serving label." [22] Thus, after fully considering all the evidentiary support in the MCA lender's favor, it concluded that it was comparatively insignificant and insufficient to overcome the determination on the other factors favoring treatment of the transaction as a loan.[23]

II. *In re GMI, Group Inc.*: MCA = Sale

In the Chapter 11 of *GMI Group, Inc.*, the Bankruptcy Court for the Northern District of Georgia held that an MCA transaction was tantamount to a sale.[24] The Debtor was a janitorial service company which entered into several MCA transactions before filing Chapter 11 bankruptcy. The MCA agreement in issue contained the following language:

> [Debtor] is selling a portion of a future revenue stream to [Defendant] at a discount, not borrowing money from [Defendant] and is solely for business

[20] *Id.* at 819.
[21] *Id.*
[22] *Id.*
[23] *Id.* at 820.
[24] *In re GMI Grp., Inc.*, No. 19-52577-PMB, 2019 WL 3774117, at 1 (Bankr. N.D. Ga. Aug. 9, 2019).

> purposes and not for personal, family or household purposes. There is no interest rate or payment schedule and no time period during which the Purchased Amount must be collected by [Defendant] . . .
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> If Future Receipts are remitted more slowly than [Defendant] may have anticipated or projected because [Debtor's] business has slowed down, or if the full Purchased Amount is never remitted because [Debtor's] business went bankrupt or otherwise ceased operations in the ordinary course of business, and [Debtor] has not breached this Agreement, [Debtor] would not owe anything to [Defendant] and would not be in breach of or default under this Agreement. [Defendant] is buying the Purchased Amount of Future Receipts knowing the risks that [Debtor's] business may slow down or fail, and [Defendant] assumes these risks based on [Debtor's] representations, warranties and covenants in this Agreement that are designed to give [Defendant] a reasonable and fair opportunity to receive the benefit of its bargain . . .[25]

The matter came before the court on cross motions for summary judgment in an adversary proceeding filed by the Debtor against the MCA Lender, Reliable Fast Cash, wherein the Debtor asserted criminal usury under New York Law, unjust enrichment, preferential transfers under 11 U.S.C. §§ 547 and 550 ("Count III"); (iv) Count IV for avoidance and recovery of fraudulent transfers under 11 U.S.C. §§ 548(a)(1)(B) and 550 ("Count IV"); (v) Count V for declaratory judgment as to the validity, priority, and extent of security interests ("Count V"); (vi) Count VI for an objection to Defendant's claim filed in the underlying bankruptcy case; (vii) Count VII for unconscionability ("Count VII"); and Count VIII for emergency temporary restraining order, preliminary injunction and permanent relief.

In evaluating the relevant factors related to whether the MCA was a sale or a loan, the Georgia Bankruptcy Court noted that the MCA Agreement contained a reconciliation provision, allowing the merchant to seek an adjustment of the amounts being taken out of its account based on its cash flow, the buyer did not have recourse against the merchant, there was no interest rate or payment schedule, and no time period during which the Purchased Amount must be collected by the Defendant. Thus, the Court indicated that the MCA Agreement bears all of the hallmarks

[25] *Id.* at 2.

of a sale of future receivables and not a loan.[26] It reasoned that there were no circumstances upon which the MCA lender could be assured of repayment because remittance of the purchased amount was completely contingent on the Debtor's collection of future receivables.[27] Interestingly, the Court also noted that, the existence of the Guaranty or the filed UCC-1 financing statement did not transform the agreement into a loan.[28]

The Ugly

Although the characterization of Merchant Cash Advance agreements as sales or loans can be a pivotal issue in bankruptcy courts, it is also worth noting that some MCA arrangements have given rise to claims by the Federal Trade Commission and the Securities and Exchange Commission.[29] In the case of the *Federal Trade Commission v. Jonathan Braun*, the United States District Court for the Southern District of New York entered a multi-million dollar judgment against the Defendant, Braun, for violating the Gramm-Leach-Bliley Act arising from Merchant Cash Advance Transactions.[30] Braun and his co-defendants engaged in a pattern of conduct related

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[26] *Id.* at 10.

[27] *Id.*

[28] *Id.*at 11 (citing *Rapid Capital Finance, LLC v. Natures Market Corp.*, 57 Misc 3d 979, 984-85 (Sup. Ct., Westchester Cnty. 2017)(explaining that execution of a security interest, though it may serve to protect the buyer's ability to collect the underlying obligation, is insufficient alone to establish absolute repayment; *Platinum Rapid Funding Group Ltd. v VIP Limousine Servs., Inc.*, 2016 WL 6603853, at 4, 2016 N.Y. Misc. LEXIS 4131, at 9 (N.Y. Sup. Ct. Oct. 27, 2016)(finding contingent repayment where "[t]he guaranty is no broader than the obligations under the Agreement, and the requirement of payment by the Guarantor is no greater than that of the Merchant.").

[29] *See Sec. & Exch. Comm'n v. Fisher*, No. 21-60624-CIV, 2022 WL 13650848 (S.D. Fla. Oct. 21, 2022)(wherein the Defendant marketed merchant cash advances as an investment product while the investor funds they solicited were used for purposes other than making merchant cash advances.); *Sec. & Exch. Comm'n v. Complete Bus. Sols. Grp., Inc.*, 538 F. Supp. 3d 1309, 1317 (S.D. Fla. 2021)(enforcement action brought by the Securities and Exchange Commission ("SEC") alleging that Defendants issued, marketed, and sold unregistered, fraudulent securities to fund short-term loans to small businesses—known as "merchant cash advances"); *Federal Trade Commission v. Braun*, No. 20-cv-4432, ECF doc. 217 (D.C. S.D. N. Y February 6, 2024 (currently on appeal to the U.S. Court of Appeals, 2nd Cir.)

[30] *See FTC v. Braun* (assessing Three Million, Four Hundred and Twenty-One Thousand and Sixty-Seven Dollars ($3,421,067.00)for monetary relief and Sixteen Million, Nine Hundred and Fifty-Six Thousand Dollars ($16,956,000.00) in civil penalties).

to MCA agreements in which they misrepresented the amount of money that customers would receive, participated in a scheme to deduct upfront fees, and withdrew more money from customer accounts than they were owed. The evidence included statistical analysis of economist noting underfunding rates of 22% to 49.1% and over-collection rates of 26.4% to 37%. The Court found that "[t]he evidence established that Mr. Braun not only participated in this illegal conduct, but did so gleefully, with little remorse" and with "complete disregard for how his actions would affect his customers (most of whom were small businesses)."[31] The Opinion includes excerpts from emails sent by Braun replete with explicit language which can best be described as callous and shocking as he boasts about his nefarious over-collection activities, including threatening to, " send a customer to jail". . ."spit in the consumer's . . . face on visiting day in prison" and telling the consumer to " drive his Honda off a cliff' and that he hoped his wife would leave him.[32]

One would expect the actions of the MCA lender in Braun to be an atypical situation with a rogue actor. That said, it highlights not only the need for clear classification of such transactions but also serves as a cautionary tale for businesses evaluating their lending options.

[31] *Id.* at 13.
[32] *Id.* at 15.