Merchant Cash Advance Claims in Bankruptcy

by

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Merchant cash advances may provide a seemingly immediate fix for a small business struggling with cash flow and who may not qualify for a traditional loan. But is this immediate fix truly a blessing for a struggling business that may not have anywhere else to turn, or is it a more nefarious scheme hiding behind the allure of receiving cash now?

What is a Merchant Cash Advance?

Merchant cash advances are an alternative to traditional financing and are often marketed to small businesses.[2] Typically, a merchant cash advance company will provide a small business with a lump-sum cash payment in exchange for purchasing a percentage of the business's future receivables. In this type of transaction, the business becomes the "seller" or merchant, and the merchant cash advance company becomes the "purchaser." Dissimilar to the hallmark of traditional loans where repayments are made in fixed installments, the basic terms of these agreements provide that the purchaser withdraws a pre-determined amount directly from the seller's account as sales are made and receivables are collected. These pre-determined amounts may be a percentage of sales or a fixed dollar amount. In some agreements, repayment takes the form of automatic ACH withdrawals, giving the purchaser direct access to the seller's bank account. Often, withdrawals are daily or weekly. Consequently, the projected repayment periods are quite short. These short repayment periods can come laden with fees and effectively high interest rates, the high cost of which the seller may not fully realize at the outset of the agreement. Far too often, this rapid rate of payback becomes too much for a small or medium business to sustain, leading it to seek out yet another merchant cash advance to cover its first one.[3] In some cases, this cycle may repeat more than once.

Despite the unsavory repayment terms of these agreements, merchant cash advances have steadily increased in popularity in recent years due to their quick approval process and accessibility.[4] Business owners are usually approved to receive funds from a merchant cash advance company within one or two days. Once approved, the advance is often immediately delivered to the seller. Thus, this alternative to traditional financing provides a fast solution to cash flow or other financing problems a business may have without subjecting it to an extensive approval process.

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[2] *Gecker v. LG Funding LLC (In re Hill)*, 589 B.R. 614, 618 (Bankr. N.D. Ill. 2018).

[3] *The Future of Merchant Cash Advances: Trends and Predictions for SMB Financing*, Pipe (Feb. 21, 2024), https://pipe.com/blog/the-future-of-merchant-cash-advances-trends-and-predictions-for-smb-financing.

[4] *Merchant Cash Advance Market Size, Share, Competitive Landscape and Trend Analysis Report, by Repayment Method, by Application: Global Opportunity Analysis and Industry Forecast, 2024-2032*, Allied Merchant Research (April 2024), *available at* alliedmarketresearch.com/merchant-cash-advance-market-A323338.

How is a Merchant Cash Advance Transaction Characterized in a Bankruptcy Case?

Merchant cash advance transactions are no strangers to the bankruptcy world. In recent years, it seems that most small business debtors under Subchapter V of Chapter 11 have at least one merchant cash advance creditor. Their characterization, along with the determination of the interests of merchant cash advance companies in bankruptcy cases have been the subject of much legal and scholarly discussion.[5] In fact, the issue can arise very quickly in many Chapter 11 cases under the guise of a motion to use cash collateral. Because most MCA Creditors file a UCC financing statement asserting an interest in receivables or other forms of cash collateral, Chapter 11 debtors must often file motions to use the collateral that allegedly secures the merchant cash advance transaction.

What is a Creditor's Interest in a Debtor's Pre-Petition Accounts Receivable?

For a creditor to have an interest in a debtor's pre-petition receivables, the debtor must have receivables as of the petition date. A merchant cash advance company's interest, if any, is subject to competing claims such as those by another creditor of a prior secured debt, like a bank with a blanket UCC lien or an IRS lien.

Bankruptcy Code § 506(a) provides:

> An allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, . . . and is an unsecured claim to the extent that the value of such creditor's interest . . . is less than the amount of such allowed claim. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.

Under § 506(a) of the Bankruptcy Code, where a debtor has little or no receivables (like a restaurant or retail business), there is no value in which an MCA Creditor can assert an allowable secured claim. In a case where a debtor had a significant amount of prior secured debt and petition date receivables of minimal value, the court found the MCA Creditor did not have a secured claim.[6] "There [wa]s no value in the pre-petition receivables to create any allowable secured claim for Creditor."[7] As such, when a debtor has little to no receivables of value to which a security interest can attach, an MCA Creditor likely has no interest in a debtor's pre-petition accounts receivable. Furthermore, even if a debtor does have value in its pre-petition receivables, the MCA Creditor purchased the "future receivables," and arguably still has no secured interest in the pre-petition receivables. Because the MCA Creditor purchased a percentage of future receivables, and typically the pre-determined daily amount is automatically taken from the business' accounts, the buyer has already received its portion of whatever pre-petition receivables the business had.

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[5] Although the structure of the merchant cash advance agreement determines whether a merchant cash advance entity is a creditor in a bankruptcy case, for purposes of the following sections, the merchant cash advance "purchaser" will be referred to as "MCA Creditor" and the "seller" will be referred to as the "debtor."

[6] *In re Watchmen Sec. LLC*, No. 24-00087-JMC-11, 2024 WL 4903363, at *4 (Bankr. S.D. Ind. Nov. 20, 2024).

[7] *Id.*

What is a Creditor's Interest in a Debtor's Post-Petition Accounts Receivable?

In a bankruptcy case, an MCA Creditor may assert that it has a secured claim in a debtor's post-petition accounts receivable. The MCA Creditor would contend that it acquired, pre-petition, the debtor's post-petition accounts receivable. Essentially, the MCA Creditor would be asking the court to rule that the debtor, pre-petition, had the ability to sell an interest in accounts receivable that may or may not come into existence, and if they do, not until post-petition. But if a "[s]ale is the transfer to the buyer of that which is being purchased,"[8] how can a debtor transfer future rights to payment to the MCA Creditor? It simply cannot. Until the rights to a payment arise, there is nothing tangible to be sold. Contemplating this in a practical sense, this is not a present transfer of property. There is nothing presently to transfer in exchange for the cash advance because the debtor does not own the receivables. They do not yet exist.

Article 9 of the Uniform Commercial Code bolsters and supports this argument. Under U.C.C. § 9-203(b)(2), for a security interest to attach, it is required that a debtor have "rights in the collateral or the power to transfer rights in the collateral."[9] Although U.C.C. § 9-204 permits parties to create a security interest in after-acquired or existing collateral, as the Official Comments to this section explain, § 9-204 "adopts the principle of a 'continuing general lien' or 'floating lien.' It validates a security interest in the debtor's existing and (*upon acquisition*) future assets, even though the debtor has liberty to use or dispose of collateral without being required to account for proceeds or substitute new collateral."[10] Accordingly, until rights to receivables are acquired, an MCA Creditor has nothing more than an unattached security interest.[11] In other words, a merchant cash advance agreement cannot effect a pre-petition transfer or sale of post-petition receivables that were not in existence pre-petition.[12]

The logical next question posited in such a situation is whether, by grant of a security interest or sale, a debtor can effect a post-petition transfer of any interest in post-petition receivables.[13] If a debtor's post-petition receivables are not "proceeds" of pre-petition collateral, the answer is "no." "Proceeds" are defined in U.C.C. § 9-102(64) as: "(A) whatever is acquired upon the sale, lease, license, exchange, or other disposition of collateral; (B) whatever is collected on, or distributed on account of, collateral; (C) rights arising out of collateral."[14] Moreover, such proceeds must be identifiable.[15] Therefore, if a debtor's proceeds arise from a service performed post-petition, those proceeds cannot effect a post-petition transfer of an interest in post-petition receivables. If there is

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[8] John F. Hilson & Stephen L. Sepinuck, *A "Sale" of Future Receivables: Disguising A Secured Loan as a Purchase of Hope*, 9 Transactional Law. 14, 15 (2019) (citations omitted).

[9] The Official Comment to U.C.C. § 9-203(b)(2) states, "[a] debtor's limited rights in collateral, short of full ownership, are sufficient for a security interest to attach. However, in accordance with basic personal property conveyancing principles, the baseline rule is that a security interest attaches only to whatever rights a debtor may have, broad or limited as those rights may be."

[10] U.C.C. § 9-204, Official Comment 2 (emphasis added).

[11] *See In re Bizgistics, Inc*., No. 3:21-BK-02197-RCT, 2022 WL 2827551, at *7 (Bankr. M.D. Fla. July 14, 2022) (explaining that when a right to payment did not exist, a security interest could not attach, nor could it be perfected).

[12] *In re Watchmen Sec. LLC*, No. 24-00087-JMC-11, 2024 WL 4903363, at *4 (Bankr. S.D. Ind. Nov. 20, 2024).

[13] Granted there are any post-petition receivables.

[14] *See also* Fla. Stat. § 679.1021(lll) (defining "proceeds" as "(1) whatever is acquired upon the sale, lease, license, exchange, or other disposition of collateral; (2) whatever is collected on, or distributed on account of, collateral; (3) rights arising out of collateral").

[15] Fla. Stat. § 679.3151 (providing that a security interest attaches to identifiable proceeds of collateral).

no pre-petition perfected interest in collateral, as arguably in any case involving an MCA Creditor, post-petition proceeds cannot be identifiable proceeds of pre-petition collateral.

Is a Merchant Cash Advance Transaction a Loan or True Sale?

Merchant cash advance agreements are products of careful and clever drafting on the MCA Creditor's part in an effort to avoid characterization as usurious loans. Hence, an issue courts are frequently presented with is whether an agreement is a loan in disguise or an actual sale of accounts receivable. The same issue arises in the context of leases disguised as financing arrangements.

It is important to note that the characterization of this type of transaction is a question of state law, as neither the Bankruptcy Code nor federal statute prescribe means for distinguishing between a loan and a true sale.[16] "The deciding factor in the 'sale' versus 'loan' dispute is generally the transfer of risk—if the 'buyer' is absolutely entitled to repayment under all circumstances, then the risk remains with the 'seller' and the transaction is considered a loan."[17] Thus, the economic substance of an agreement rather than its form or terminology, controls this decision.[18]

Courts typically look to three factors in determining whether repayment is contingent or absolute.[19] Such factors are, "(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."[20] As is the case with many multi-factor analyses, any one factor alone rarely mandates a certain treatment.[21]

The inclusion of a reconciliation provision in an agreement and the occurrence of actual reconciliations by the debtor typically tip the analysis in favor of finding a true purchase of receivables.[22] This is so because of the flexibility a debtor is afforded in its ability to adjust the amount of its daily payment obligation in consideration of actual sales. For example, performing this function is akin to a company adjusting its accounts receivable for uncollected receipts from a sale of merchandise to a customer. Yet, because MCA Creditors can structure their agreements in ways that benefit themselves and push the risk on debtors, the presence of a reconciliation provision in an agreement does not always tilt the scale in favor of finding a true purchase. In *LG Funding, LLC v. United Senior Properties of Olathe, LLC*, a reconciliation contained language articulating that the MCA Creditor could adjust the amounts due "at [its] sole discretion and as it

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[16] *CapCall, LLC v. Foster* (*In re Shoot the Moon, LLC*), 635 B.R. 797, 811-12 (Bankr. D. Mont. 2021).
[17] *In re McKenzie Contracting, LLC*, No. 8:24-bk-01255-RCT, 2024 WL 3508375, at *2 (Bankr. M.D. Fla. July 19, 2024) (citations omitted). *See also Landmark Funding Grp. LLC v. Alt. Materials LLC*, No. 534708/2022, 2024 N.Y. Misc. LEXIS 852, at *7 (Sup. Ct. Feb. 29, 2024) (explaining that for the agreement to be considered a purchase of accounts receivable, "there must be a real risk on the part of the [MCA Creditor] that the [debtor] may have reduced revenues or even no revenue.").
[18] *Id.*; *Fleetwood Servs., LLC v. Richmond Capital Grp. LLC*, No. 22-1885-CV, 2023 WL 3882697, at *2 (2d Cir. June 8, 2023) ("'substance—not form—controls' when a court determines whether a transaction is a loan." (quoting *Adar Bays, LLC v. GeneSYS ID, Inc.*, 37 N.Y.3d 320, 334 (2021)).
[19] *LG Funding LLC v. United Senior Props. of Olathe LLC*, 122 N.Y.S.3d 309, 312 (N.Y. App. Div. 2020).
[20] *Id.* (citing *K9 Bytes Inc. v. Arch Cap. Funding LLC*, 57 N.Y.S.3d 625, 632 (Sup. Ct. 2017)).
[21] 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 (1991).
[22] *In re McKenzie Contracting*, 2024 WL 3508375, at *2 (citing *Lateral Recovery LLC v. Queen Funding, LLC*, No. 21 CIV. 9607 (LGS), 2022 WL 2829913, at *5 (S.D.N.Y. July 20, 2022)).

deems appropriate."[23] The MCA Creditor retained complete discretion over payment adjustments, and thus, did not assume any risk that it would yield lower revenues than anticipated.[24]

The ability of the debtor to adjust payments does shed light on the second factor. If a debtor can and does adjust the amount of a payment, then the agreement does not have a finite term. The term period changes upon an adjustment of the amount being paid to the MCA Creditor. Fixed terms are a characteristic of loans; whereas indefinite terms suggest the MCA Creditor has assumed the risk of uncollectible receivables.[25]

The third factor focuses on the risk associated with the seller's non-payment. In a true sale, the purchaser bears this risk. Whereas, in the context of a loan, the obligation to repay is absolute. Provisions within these agreements dictating that the debtor's bankruptcy triggers default place a finger on the scale in favor of finding the agreement is in fact a loan. These agreements almost always include one or more personal guarantees that business owners must sign, likewise pointing towards classification as a loan.[26] Provisions such as these suggest that the MCA Creditor has not assumed the risk of loss; rather, the MCA Creditor is absolutely entitled to repayment. It is this very concept of entitlement to absolute repayment that drives the characterization of a merchant cash advance transaction.

Characterizing a transaction as a loan in which a debtor granted a security interest in receivables would not be without problems for an MCA Creditor. Under 11 U.S.C. § 552(a), "property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case." In essence, the Bankruptcy Code does not allow a pre-petition interest to extend to property acquired by the debtor post-petition.[27] There is, however, a narrow exception to this general rule in § 552(b) if the buyer demonstrates a connection between pre-petition and post-petition property.[28] As discussed above, a connection is unlikely, for instance, in a case where a debtor provides services.

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[23] *LG Funding*, 122 N.Y.S.3d at 312.

[24] *Id*.

[25] *In re McKenzie Contracting*, 2024 WL 3508375, at *2 (citing *Lateral Recovery*, 2022 WL 2829913, at *6).

[26] *Fleetwood Servs., LLC v. Ram Capital Funding, LLC*, No. 20-cv-5120 (LJL), 2022 WL 1997207, at *13 (S.D.N.Y. June 6, 2022) ("Courts have observed that personal guarantees are 'consideration[s] pointing toward treating the agreement being treated as a loan rather than a receivables purchase' but have also observed that personal guarantees that are limited by the contingent nature of the merchant's obligations under an agreement may not render the agreement a loan." (quoting *Pirs Cap., LLC v. D & M Truck, Tire & Trailer Repair Inc*., 129 N.Y.S.3d 734, 740 (N.Y. Sup. Ct. 2020))). *But see Guttman v. EBF Holdings, LLC (In re Glob. Energy Servs.)*, Case No. 21-17305-NVA, Adv. No. 23-00188, 2025 Bankr. LEXIS 774, at *25 (Bankr. D. Md. Mar. 31, 2025) (stating that personal guarantees are other indicia of a secured transaction but holding that the personal guaranty in that case did not support a finding that the MCA agreement was a loan because it did not absolutely guarantee payment in the event the debtor defaulted and did not shift the risk of default away from the MCA Creditor).

[27] *In re Watchmen Sec. LLC*, 2024 WL 4903363, at *7 (citations omitted).

[28] 11 U.S.C. § 552(b)(1) provides, "if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to proceeds, products, offspring, or profits of such property, then such security interest extends to such proceeds, products, offspring, or profits acquired by the estate after the commencement of the case to the extent provided by such security agreement and by applicable nonbankruptcy law, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise."

If the factors weigh in favor of a true sale, any intended transfers of post-petition receivables must have been in accordance with 11 U.S.C. § 363. If any such transfer were made without comporting with the Bankruptcy Code, it would be deemed an unauthorized transfer. Such unauthorized transfers are avoidable according to 11 U.S.C. § 549.[29]

What are the Other Considerations for a Debtor Engaging in a Merchant Cash Advance Transaction?

A bankruptcy court's characterization of a merchant cash advance transaction can be a threshold issue for state law usury claims that could take the form of an objection to a claim or an adversary proceeding in a bankruptcy case. If a transaction is considered a true sale, it is not subject to usury laws.[30] However, if a transaction is considered a loan, then State usury laws are implicated. Depending on the repayment percentage or fixed monthly remittance amount, the interest rates in a merchant cash advance transaction can skyrocket quite readily, far surpassing a State's maximum simple interest per annum. For example, the maximum simple interest rate in Florida for transactions under $500,000 is 18 percent.[31] Therefore, once a court characterizes a transaction as a loan, a debtor may bring a usury claim.[32] Additionally, claims objections may be pertinent. If an MCA Creditor files a proof of claim, a debtor may object to such filing and seek to redesignate the transaction as a loan.[33] Be that as it may, many MCA Creditors do not file proofs of claim to avoid the jurisdiction of the Bankruptcy Court.

Tax law, accounting standards, and regulatory agencies may provide useful insight to courts for characterizing merchant cash advance transactions. From an accounting standpoint, a traditional loan is recorded on a recipient's books as an increase to cash and the creation of a corresponding loan payable (liability). In a basic sense, as the recipient pays back the loan, it will decrease its cash and the corresponding loan payable, and record interest expense. Alternatively, when a sale occurs, the seller records revenue and the receipt of cash, or if cash was not received, an increase to its accounts receivable. Interestingly, contemplating a merchant cash advance transaction in combination with these two rudimentary concepts, it appears that a merchant cash advance transaction is more akin to a traditional loan transaction.

Yet much of accounting is anything but dealing with rudimentary transactions. An area that the Financial Accounting Standards Board ("FASB") has contemplated is the balance sheet treatment of transferred accounts receivable. Financial Accounting Standards Board Statement 77 ("FASB 77"), "clarif[ies] the circumstances under which a transfer of receivables with recourse

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[29] 11 U.S.C. § 549(a) states, "[e]xcept as provided in subsection (b) or (c) of this section, the trustee may avoid a transfer of property of the estate— (1) that occurs after the commencement of the case; and (2) (A) that is authorized only under section 303(f) or 542(c) of this title; or (B) that is not authorized under this title or by the court."

[30] *GMI Grp. Inc. v. Unique Funding Solutions LLC (In re GMI Grp. Inc.),* 606 B.R. 467, 483 (Bankr. N.D. Ga. 2019).

[31] Fla. Stat. § 687.03.

[32] *See CapCall, LLC v. Foster (In re Shoot the Moon, LLC)*, 635 B.R. 797, 813 (Bankr. D. Mont. 2021) (characterizing a merchant cash advance transaction as a loan based upon the agreement providing the debtor's principal executed an absolute guaranty of the obligations with other recourse and granting the MCA Creditor a broad security interest in all the debtor's assets, then applying Montana law to conclude that the interest charged in the transaction was usurious, and ultimately awarding a $1,216,685 judgment based on the usuary claim).

[33] *See In re GMI Grp.,* 606 B.R. at 487 (finding a merchant cash advance transaction for which the agreement necessitated the debtor keep at least twice the amount of the daily payment in its account and that failure to do so was an event of default, triggering full unconditional liability and rendering the risk of nonpayment illusory to be a loan).

should be recognized by the transferor as a loan or, alternatively, as a sale."[34] For a transaction to receive sale treatment, the transferor must "surrender[] control of the future economic benefits embodied in the receivables" to the point where the transferor does not have the option to repurchase the receivables at a later date.[35] In addition, FASB 77 requires that the transferor's obligation under the recourse provisions be reasonably estimable, and it prohibits the transferee from requiring the transferor to repurchase the receivables except pursuant to the recourse provisions.[36] FASB's focus appears to be on determining whether there has been a transfer of the benefits of ownership and predicting actual recourse exposure.[37] Inherently, the accounting profession is concerned with companies' recordkeeping and accurate reflection of their financial positions. Nevertheless, its position on classifications may be a source of support for courts in reaching their own legal determinations on the character of a merchant cash advance transaction.

Takeaways: Risks Potential Sellers Should be Aware of Before Entering into a Merchant Cash Advance Agreement

As merchant cash advance companies continue to rise in popularity and general economic conditions deteriorate, those contemplating entering into an agreement with one would be advised to carefully perform their due diligence. Before turning to a merchant cash advance company for funding, prospective sellers should verse themselves in the other available financing options (or a bankruptcy filing). If, upon performing due diligence on other financing avenues, a merchant cash advance company prevails as the most appealing source of funding, it is crucial that a prospective seller review a tentative agreement with the utmost scrutiny. Remember that merchant cash advance companies often masquerade as nothing more than simple funders of cash up front with reasonable repayment terms. Indeed, this may occasionally prove to be the case, but more frequently, these agreements are laden with harsh and unforgiving terms that may take more of a toll on a business than a traditional loan. In any event, dealing with MCA Creditors can be challenging; nonetheless, a bankruptcy filing will permit a business to more effectively manage merchant cash advance claims within the confines of the Bankruptcy Code.

[34] *Reporting by Transferors for Transfers of Receivables with Recourse*, Statement of Financial Accounting Standards No. 77, § 1 (Fin. Accounting Standards Bd. 1983).
[35] *Id.*
[36] *Id.*
[37] Aicher, *supra* note 21 at 203-04.