

RECENT LITIGATION ILLUSTRATES WHY MERCHANT CASH ADVANCES ARE NOT LOANS

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To the casual observer, the African hyena is unquestionably a type of wolf or wild dog. No one can deny that hyenas and wolves look alike. For zoological purposes, however, the hyena is a type of feline; albeit one that bears an uncanny resemblance to a canine. In the financial world, a merchant cash advance, or “MCA,” is analogous to a hyena. An MCA strongly resembles a loan, but for legal purposes constitutes a purchase and sale contract, i.e. it’s a different animal.

Analogies aside, MCA plays an important role in small business financing. The merchant cash advance industry arose during the recent financial crisis when many banks ceased making loans to small businesses. If accurately understood and properly structured, a merchant cash advance offers mutual benefits to both

suppliers and recipients of this increasingly popular source of funding.

New York Litigation Summary

Because New York has both a relatively low usury cap and a high population of small businesses, New York courts are frequently called upon to interpret whether a given MCA arrangement constitutes a loan. As a result, a review of relevant New York cases is helpful in understanding the key differences between the two.

The key difference between an installment loan and a merchant cash advance was summarized by the Supreme Court of New York, Nassau County in its recent March 16, 2017 decision in *IBIS Capital Group, LLC*

*v. Four Paws Orlando LLC*¹ as follows: “For a true loan it is essential to provide for repayment absolutely and at all events. . . [In contrast, where] payment or enforcement [of an MCA] rests upon a contingency, the [MCA] agreement is valid even though it provides for a return in excess of the legal rate of interest.”

Briefly, in the case of a loan, all funds

In the case of a merchant cash advance, a person who advances funds to another in exchange for an ownership interest in that party’s business receivables may see a profit, or suffer a loss, depending on how those receivables perform. The distinction between a loan and a merchant cash advance matters because it is not uncommon for the cost of an MCA arrangement to equate to an interest rate which exceeds the usury cap of most states.

that were advanced to the recipient must be repaid to the advancing party (i.e., the lender) in full on or before the specified payment due date, usually with interest added. In the case of a merchant cash advance, on the other hand, a person who advances funds to another in exchange for an ownership interest in that party’s business receivables may see a profit, or suffer a loss, depending on how those receivables perform. The distinction between a loan and a merchant cash advance matters because it is not uncommon for the cost of an MCA arrangement to equate to an interest rate of 150% or higher, which far exceeds the criminal usury cap of most states. For example, New York’s criminal usury limit is 25%.

On October 25, 2016, the New York Supreme Court issued a decision in *Pearl Capital Rivis Ventures, LLC v. RDN Construction, Inc.*² that turned on the absence of language in the parties’ contested MCA agreement specifying that the sale of receivables to the maker/defendant was without recourse to the seller/plaintiff. In the absence of such language, the court found that the plaintiff was absolutely obligated to repay and the parties’ arrangement therefore amounted to a loan with a usurious interest rate of approximately 180% per year.

In this regard, the court drew a distinction between the risk that purchased receivables may not perform as expected and “the risk of nonpayment that is inherent in every loan and that may only be compensated for by

statutory interest; the risk of loss by the death or insolvency of the borrower is the risk that every person runs who lends money on personal security only.”³

In *IBIS Capital Group*, the New York Supreme Court first cited numerous New York cases in support of the position that in order to constitute a loan, the principal sum given to one party must be absolutely repayable and not contingent upon future events.⁴ The court then proceeded to review specific provisions from the parties MCA agreement stating that: (i) IBIS would receive a percentage of Four Paws’ daily sales, (ii) the transaction was not a loan, and (iii) the agreement would be governed by the Uniform Commercial Code (which does not govern loans).⁵ According to the

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court, the foregoing offered persuasive evidence that the contested transaction did not constitute a loan and hence was not subject to usury.⁶

The *IBIS Capital Group* decision is notable for several other reasons. First, in finding that the agreement did not create a loan, the court addressed defendant Four Paws' contention that the parties' agreement established a "set and finite fixed daily payment" that could be used to calculate a usurious interest rate. In this regard, the court noted that it was unable to find such a provision, but opined that even if one had existed, the principal repayment would be contingent upon Four Paws ability to sell their product, noting that the agreement called for Four Paws to repay to IBIS any amounts received directly related to future sales.⁷

Second, the court noted that the MCA agreement included no due date

upon with all amounts advanced would become due and payable.⁸


Finally, the court opined that even if the agreement had established a loan, Four Paws could not show that IBIS had intended to charge a usurious rate of interest, which is required in order to prove criminal usury under New York law. In this regard, the court noted that "[t]he only time the parties could have possessed sufficient data to calculate the comparable equivalent to an interest rate, would have been too late for IBIS to have possessed usurious intent."⁹

MCA Deal Structure

That a merchant cash advance closely resembles a loan is understandable. For example, in the case of a sole proprietorship, it would be imprudent not to underwrite the individual owner of the business for either relationship – in the case of an MCA, for the purpose of ascertaining whether and to what extent continued funding of the business might be available.

In addition, as in *IBIS Capital Group*, the parties may find it advantageous to structure payments in a manner similar to a loan, but ultimately subject to the performance of the receivables.

Furthermore, to compensate for the risk of making the merchant cash advance, it is not uncommon for the party advancing funds to charge a factor rate, which may seem analogous to a finance charge. What ultimately matters, however, is whether repayment hinges upon the performance of the purchased receivables or an absolute obligation to repay on the part of the individual business owners, which might take the form of a personal guarantee of financial performance or costly late charges that are payable from sources besides the receivables and which effectively remove the business risks associated with the latter.

In sum, having a full and accurate understanding of a merchant cash advance is important for both recipients and providers of capital. For the recipient, knowing that there is nothing inherently untoward about a merchant cash advance and understanding why usury does not apply can be helpful in addressing the true risks associated with such relationships. For the provider, having sound knowledge of structuring merchant cash advance agreements can be helpful in avoiding unnecessary litigation and potentially costly pitfalls. 

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Notes

- 1 *IBIS Capital Group, LLC v Four Paws Orlando LLC*, 2017 N.Y. Misc. LEXIS 884, 2017 NY Slip Op 30477(U) (N.Y. Sup. Ct. Mar. 10, 2017).
- 2 *Pearl Capital Ravis Ventures, LLC v RDN Constr., Inc.*, 54 Misc. 3d 470, 41 N.Y.S.3d 397, 2016 N.Y. Misc. LEXIS 3945, 2016 NY Slip Op 26344 (N.Y. Sup. Ct. 2016).
- 3 *Pearl Capital*, 2016 N.Y. Misc. LEXIS 3945, at * 7.
- 4 *IBIS Capital Group* at *2.
- 5 *Id.* at *8.
- 6 *Id.* at *9.
- 7 *Id.* at **8-9.
- 8 *Id.* at *9.
- 9 *Id.* at *10.