

COUNTERING THE USURY DEFENSE TO MERCHANT CASH ADVANCE AGREEMENTS – PART 1

RECONCILIATION

A merchant cash advance is, in its simplest form, a buy-sell transaction where the advancer is the purchaser and the merchant is the seller. The purchaser offers a business (“merchant”) cash on hand in exchange for an interest in a certain amount of the merchant’s future receivables.

For example, a purchaser pays a merchant \$100,000 to purchase \$150,000 of the merchant’s future receivables (the “purchased amount”). The purchaser debits the merchant’s account in a specified amount, representing a percentage of the merchant’s anticipated receivables. The merchant’s account is debited directly, either daily, weekly, monthly, or on another schedule, until the purchased amount is received by the purchaser.

Assuming the scheduled debits are calculated such that the purchased amount is to be received by the purchaser in one year, the above transaction represents a 50% “interest rate” per annum on what appears to be a loan. However, a merchant cash advance – if properly structured and executed – is not a loan. This agreement is secured by a personal guaranty, a UCC-1 financing statement, and/or a confession of judgment. Various protections exist for the purchaser in the event of a default, but bankruptcy, in most instances, is not an event of default. This is perhaps why many merchant cash advances are not subject to New York State’s criminal usury laws. Nevertheless, in the event of a default, usury is typically brought as a defense by the merchant in the event of a lawsuit.

Reconciliation as a Defense to Usury

Under New York Penal Law § 190.40, a person commits criminal usury where he "knowingly charges, takes or receives interest on a loan or forbearance of any money or other property, at a rate exceeding twenty-five percent per annum." However, criminal usury does not apply to loans above \$2,500,000.

Reconciliation is principally what distinguishes a merchant cash advance from a loan. Generally speaking, reconciliation provisions permit the merchant to change the amount debited by the purchaser to more closely represent the percentage of the merchant’s actual receivables. The burden tends to be on the merchant to make the request and provide books and records supporting the reconciliation request.

"In order for a transaction to constitute a loan, there must be a borrower and a lender; and it must appear that the real purpose of the transaction was, on the one side, to lend money at usurious interest reserved in some form by the contract and, on the other side, to borrow money upon the usurious terms dictated by the lender."¹

¹ *Donatelli v. Siskind*. 170 AD2d 433, 434 (2nd Dept, 1991).

In analyzing a usury defense, courts consider the transaction "in its totality and judged by its real character rather than by the name, color, or form which the parties have seen fit to give it."² To determine whether a transaction is a loan masked as a purchase for future receivables, courts examine whether the plaintiff is "absolutely entitled to repayment under all circumstances"³.

The Second Department in *LG Funding* held that "courts weigh three factors when determining whether repayment is absolute [making it a loan] or contingent [making it a purchase for future receivables]: (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"⁴.

Courts analyze reconciliation provisions closely, and abhor reconciliation provisions that are too discretionary. For example, the court in *Advance Services Group LLC v Acadian Properties Austin LLC* held:

The reconciliation provision in the Merchant Agreement, like the reconciliation provision at issue in the *LG Funding* decision, provides that Advance "may, upon Merchant's request, adjust the amount of any payment due under this Agreement at [its] sole discretion and as it deems appropriate in servicing this Agreement" (emphasis added). Since the reconciliation provision gave Advance sole discretion for any payment adjustment, this suggests that Advance's entitlement to repayment was absolute, rather than contingent, and therefore is indicative of a loan, as a matter of law (see *LG Funding LLC*, 181 AD3d at 666)."⁵

A similar sentiment was reached in the First Department:

Plaintiffs also allege sufficiently that the subject agreements were loans subject to usury laws, to wit, the discretionary nature of the reconciliation provisions, the allegations that defendants refused to permit reconciliation, the selection of daily payment rates that did not appear to represent a good faith estimate of receivables, provisions making rejection of an automated debit on two or three occasions without prior notice an event of default entitling defendants to immediate repayment of the full uncollected purchased amount, and provisions authorizing defendants to collect on the personal guaranty in the event of plaintiff business's inability to pay or bankruptcy (see *LG Funding, LLC v. United Senior Props. of Olathe, LLC*, 181 A.D.3d 664, 665-666, 122 N.Y.S.3d 309 [2d

² *LG Funding LLC v United Senior Props. of Olathe, LLC*. 181 AD3d 664, 665 (2d Dept, 2020)

³ *K9 Bytes, Inc. v Arch CapUal Funding, LLC*, 56 Misc 3d 807, 816 (Sup. Ct Westchester County, 2017)

⁴ *LG Funding LLC*, 181 AD3d at 666

⁵ 70 Misc 3d 1225(A) (Sup Ct, Kings County, March 12, 2021)

Dept. 2020]). If the agreements are found to be loans, criminal usury will be a defense to their enforcement, rendering them void.⁶

While a fact intensive inquiry, it appears a purchaser may protect itself by, counterintuitively, increasing its risk. This suggests that a purchaser must impose a contractual duty upon itself to reconcile. Breaching that duty may prevent recovery and expose the purchaser to criminal prosecution. Reconciliation provisions, therefore, must not only be carefully drafted, but properly implemented.

⁶ *Davis v Richmond Capital Group, LLC*, 194 AD3d 516 (1st Dept. 2021).