

New York Criminal Usury as a Claim in Bankruptcy

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A merchant bankruptcy poses several dangers for revenue-based commercial funders. Most obviously, from a business standpoint, bankruptcy disrupts the merchant's ongoing revenue generation and the transfer of revenue to the funder. However, bankruptcy also poses important compliance considerations. First, bankruptcy can impact the risk that a provider's transaction may be deemed to be a loan. Second, if the transaction is considered a loan, bankruptcy affects how the issue of usury is addressed. Several recent bankruptcy cases have emphasized that latter issue.

Revenue-based financing transactions (also known as merchant cash advance transactions) are often structured as sale transactions, rather than loans. A funder provides money to a merchant in return for a share of the merchant's future revenue—the funder does not provide money as a loan that must be repaid. However, whether that structure works as intended depends in part on how the transaction's terms address bankruptcy. Bankruptcy is one of the factors impacting recharacterization.

Recharacterization refers to the risk that a court may conclude that a transaction facially structured as a sale is actually a loan in disguise. Courts considering recharacterization often look to New York law, as many revenue purchase agreements select that state as the governing law for the transaction.

Those courts generally apply a three-part test to determine whether a transaction is properly characterized as a revenue-purchase transaction or a loan. One part of the test is whether the merchant agreement provides for recourse if the merchant declares bankruptcy (the other factors address reconciliation and the term of the agreement).

If an agreement declares that a merchant will be in default if the merchant files for bankruptcy, it suggests that the funder did not assume the risk that the merchant's revenue may be less than expected. The assumption of such risk is one of the characteristics of a sale. In a loan transaction, on the other hand, a provider does not assume that risk. Rather, the merchant is subject to a contractual obligation to pay even if the business slows down or ceases.

Accordingly, bankruptcy is a compliance issue that needs to be considered when structuring the terms of a revenue purchase agreement. Knowledgeable providers make sure their revenue purchase agreements do not make it an event of breach if the merchant enters bankruptcy.

Bankruptcy also impacts a second compliance consideration, which is the consequence of a court determining a transaction is a loan - primarily, usury. While sale transactions are often excluded from state usury limits, loans are not. As a result, recharacterization goes hand-in-hand with a claim that the "disguised loan" is usurious under state law.

New York's usury law is complex, involving different limits that apply depending on the rate, the transaction size, and the type of borrower. The state has both a civil usury law and a criminal usury law. The civil usury rate is 16% per year for many loans. However, a corporation or limited liability company is barred from raising civil usury as a defense in any action. That means a merchant generally cannot assert civil usury as a defense if the merchant is a corporation or LLC.

The same limitation does not apply to the state's criminal usury rate, which is 25% per year. A lender that charges more than 25% in connection with a commercial loan may have a problem in New York even if the borrower is a corporation or LLC. That problem can be significant, as exceeding the criminal usury rate can void the transaction.

However, there is an additional nuance that comes into play. A corporation or LLC is allowed to assert criminal usury as a defense, but courts have held that the borrower cannot assert criminal usury as an affirmative claim against the lender. In other words, if a funder sues the borrower for repayment, the borrower is allowed to defend by claiming criminal usury. The borrower, however, generally cannot sue the funder seeking monetary damages for a claim of criminal usury. Courts commonly describe this distinction as permitting criminal usury to be used as a shield, but not as a sword.

There is an exception to the exception, though. Courts are more willing to allow a borrower to assert criminal usury as a claim in a bankruptcy proceeding. That was the situation in several recent bankruptcy cases, where courts in Michigan, Idaho, and Texas each considered whether criminal usury may be asserted as a claim in bankruptcy.

The Michigan case, *In re Heritage Collegiate Apparel, Inc.*,¹ involved a clothing company that went bankrupt after entering into several agreements to sell future receipts to a funding provider. As part of the bankruptcy proceedings, the funder filed a proof of claim against the bankruptcy estate. The merchant then sued the provider, claiming that the sale transactions were in fact usurious loans under New York law.

Without considering the likelihood that the agreements might ultimately be deemed to be loans, the court instead focused on the permissibility of the merchant's criminal usury claim. The funder argued that the merchant's claim was not allowed because it sought affirmative relief - usury was not being raised as a defense because the provider had not sued the merchant for repayment.

The court disagreed, finding that a debtor in bankruptcy may bring a claim under the criminal usury statute if the claim is in fact an objection to a creditor's claim against the bankruptcy estate. The court reasoned the debtor is merely defending against a claim for repayment of a loan. However, as a technical matter, the court found that the merchant's claim was not written as an objection to the provider's claim. Noting that it would be easy for the merchant to amend the claim to clarify what relief was being sought, the court gave the merchant leave to do so.

In a related case² involving the same merchant but a different funding provider, the same claims were raised and the Michigan court initially reached the same conclusion - New York criminal usury may be asserted as a claim by a merchant if the claim is structured as an objection to the funder's proof of claim. However, in this case, the court found that the funding amount was such that New York's criminal usury limit did not apply. The funder acquired \$3,550,000 in revenue, and the criminal usury limit applies only to transactions of \$2.5 million or less. As a result, the merchant's claim would fail even if asserted as a defense to the funder's claim in bankruptcy.

The merchant attempted to argue that the transaction actually fell below the \$2.5 million threshold because the provider advanced only \$400,000 to the merchant, with the remainder paid to another provider on the merchant's behalf. The court found that argument was contradicted by the written agreement.

A case out of Idaho, *In re HMM Constr., LLC*,³ involved a similar fact pattern. A construction company entered into a revenue purchase agreement to sell future receipts at a discount. The merchant actually transferred all of the sold receipts, but when the company later entered bankruptcy, the bankruptcy trustee sued the provider. The trustee sought declaratory relief that the loan was void for violating New York's criminal usury rate. The court first considered whether there was sufficient evidence to recharacterize the sale as a loan. Finding that there was sufficient evidence, at least to survive dismissal, the court next considered the same issue raised in the Michigan cases - whether a usury claim was inappropriately asserted as affirmative relief, rather than a defense.

The Idaho court found that if the trustee was asserting usury as a "sword to void the Agreement" or as a way to obtain a recovery, the claim would be dismissed without leave to amend. However, to the extent the trustee was asserting usury not as an affirmative claim but only as a factor impacting the trustee's other claims (transfer avoidance or claim disallowance), the trustee was allowed to amend the claim to clarify the relief it sought.

Finally, a set of cases from Texas addressed the same issues. *In re Anadrill Directional Servs. Inc.*⁴ involved a bankruptcy trustee's claim that a merchant cash advance agreement was actually a usurious loan, in violation of New York's criminal usury rate. After acknowledging the three-part recharacterization test under New York case law, the court spent little time finding that the transaction had the hallmarks of a disguised loan, allowing the trustee to survive a motion to dismiss.

The court then considered the issue of usury as an affirmative defense. The court noted that other bankruptcy courts have allowed an allegation that a loan is void to support other bankruptcy-related claims, such as a claim of preferential transfer. As a result, the court held that the trustee stated a plausible claim for relief in that the void loan would not provide reasonably equivalent value under bankruptcy law.

A related Texas case⁵ involved the same merchant and judge, but different funders. The outcome was the same, with the court finding that the trustee stated a plausible claim by alleging that the "loan" was void and would not provide reasonably equivalent value for bankruptcy purposes.

These cases underscore two practical lessons for revenue-based funders. First, careful drafting remains essential to minimize recharacterization risk under New York's three-part test. Second, providers must carefully consider how to proceed once a merchant enters bankruptcy, as courts may permit criminal usury arguments to proceed in instances when those claims would not otherwise be allowed.

¹ *In re Heritage Collegiate Apparel, Inc.*, No. 24-47922, 2026 WL 159535 (Bankr. E.D. Mich. Jan. 20, 2026)

² *In re Heritage Collegiate Apparel, Inc.*, No. 24-47922, 2026 WL 166928 (Bankr. E.D. Mich. Jan. 20, 2026)

³ *In re HMM Constr., LLC*, No. 23-00191-NGH, 2026 WL 171515 (Bankr. D. Idaho Jan. 21, 2026).

⁴ *In re Anadrill Directional Servs. Inc.*, No. 23-31199, 2026 WL 234908 (Bankr. S.D. Tex. Jan. 28, 2026).

⁵ *In re Anadrill Directional Servs. Inc.*, No. 23-31199, 2026 WL 305023 (Bankr. S.D. Tex. Feb. 4, 2026).

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