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# Human Equity? Regulating the New Income Share Agreements


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# Human Equity? Regulating the New Income Share Agreements

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*A controversial new financing phenomenon has recently emerged. New “income share agreements” (“ISAs”) enable an individual to raise funds by pledging a percentage of her future earnings to investors for a certain number of years. These contracts, which have been offered by entities such as Fantex, Upstart, Pave, and Lumni, raise important questions for the legal system: Are they a form of modern-day indentured servitude or an innovative breakthrough in human financing? How should they be treated under the law?*

*This Article comprehensively addresses the public policy and legal issues raised by ISAs and articulates an analytical approach to evaluating and regulating these agreements. While there has been a nascent movement in favor of enacting overarching regulatory schemes to govern these new arrangements, this Article suggests that we should resist that trend because a unified approach is likely to create more problems than it solves. Instead, we suggest the adoption of a case-by-case approach that examines each ISA’s distinctive economics and draws analogies to more familiar financial arrangements in designing its legal treatment. Such case-by-case regulation is likely to generate rules that are more equitable and efficient. We offer a multifactor framework for implementing this “regulation by analogy.”*

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## I. INTRODUCTION

In October 2013, Fantex, Inc. launched a platform that allows the public to buy and sell shares that track the brand performance of a professional football player.<sup>1</sup> The athlete agrees to pay Fantex a

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1. See, e.g., Fantex, Inc., Prospectus (Form 424B1) (Apr. 25, 2014), available at [https://fantexbrands.com/files/Final%20Fantex%20Vernon%20Davis%20Prospectus\\_v001\\_f1o896.pdf](https://fantexbrands.com/files/Final%20Fantex%20Vernon%20Davis%20Prospectus_v001_f1o896.pdf), archived at <https://perma.cc/XP8V-R8KF> (describing Fantex’s issuance of stock tracking the Vernon Davis brand).

percentage of his future earnings attributable to NFL and related activities in exchange for a lump-sum payment up front. Shareholders earn dividends based on payments received by Fantex from the athlete. Although the Fantex stock offering is actually of shares in Fantex, Inc., the popular press has not hesitated to characterize the offering as an opportunity to buy shares or to invest in a football player.<sup>2</sup>

The Fantex transaction is not unique. Rather, it is just one example of a new type of financing arrangement that has recently emerged: income share agreements (“ISAs”). These agreements, which have arisen in contexts as diverse as professional sports, education, and startup financing, possess a critical feature in common: an individual seeking immediate financing obtains funds by pledging a percentage of her future income to investors for a certain number of years. ISAs represent a notable departure from traditional forms of individual lending (e.g., student loans or venture debt) because they effectively grant the funding provider the upside if earnings are higher than expected and the downside risk if they are lower. As such, they raise a number of important challenges for the legal system, including questions of whether they should be permitted and, if so, how they should be regulated. In this Article, we take up the important normative and legal questions raised by these new arrangements and propose a framework for designing their regulation.<sup>3</sup> This Article constitutes the first serious attempt in the legal literature to comprehensively address the legal and regulatory issues raised by ISAs and to articulate a generalized analytical approach to their regulation.<sup>4</sup>

ISAs have developed against the backdrop of Internet platforms that reach millions, a continued credit crunch in borrowing, and several decades of creative financial contracts. Over the past two years,<sup>5</sup> a

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2. See, e.g., Patrick Clarke, *Fantex Holdings Will Allow Fans to Buy, Sell Stock in Arian Foster, Pro Athletes*, BLEACHER REPORT (Oct. 17, 2013), <http://bleacherreport.com/articles/1814830-fantex-holdings-will-allow-fans-to-buy-sell-stock-in-arian-foster-pro-athletes>, archived at <http://perma.cc/XQU3-X9LV> (suggesting, in its headline, that the stock is an investment in Arian Foster himself).

3. This Article develops more fully the concepts introduced in our prior essay. See Shu-Yi Oei & Diane M. Ring, *The New “Human Equity” Transactions*, 5 CALIF. L. REV. CIRCUIT 266 (2014).

4. The few other scholarly treatments have focused on more discrete issues, such as the treatment of ISAs under securities and tax law. See Oei & Ring, *supra* note 3; Jeff Schwartz, *The Corporatization of Personhood*, 2015 U. ILL. L. REV. (forthcoming), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2466720](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2466720).

5. See, e.g., Kate Rogers, *Is the Private Sector Going to Fix the Student Debt Problem?*, FOXBUSINESS (Apr. 25, 2014), <http://www.foxbusiness.com/personal-finance/2014/04/25/is-private-sector-going-to-fix-student-debt-problem/>, archived at <http://perma.cc/VG67-WNAN>.

growing number of for-profit companies,<sup>6</sup> nonprofits,<sup>7</sup> and government entities<sup>8</sup> have begun offering variations of these arrangements. Although ISAs have precursors in older arrangements, such as Bowie Bonds<sup>9</sup> or Milton Friedman's human capital contracts,<sup>10</sup> the current social and financial environment, paired with the availability of Internet technology, magnifies their potential impact and proliferation.

Even as their availability increases, however, ISAs pose serious yet unanswered questions for the legal system: Should they be freely permitted? Do they cross the line into ownership or equity-like interests in humans—a de facto “incorporation” of humans?<sup>11</sup> Do these arrangements involve excessive relinquishments of personal freedom and autonomy? Do they raise Thirteenth Amendment problems? If some or all of these transactions should be encouraged or at least permitted, how should they be regulated under securities, bankruptcy, contract, tax, and consumer protection law? Which agencies or legal actors should be responsible for their regulation? Because the new generation of ISAs has only recently emerged, the legal literature has barely begun to grapple with these questions.<sup>12</sup>

6. See, e.g., PAVE, <http://www.pave.com>, archived at <https://perma.cc/5YQK-B7HE> (last visited Jan. 13, 2015).

7. See, e.g., *About Lumni*, LUMNI, INC., <http://www.lumni.net/about/>, archived at <http://perma.cc/G7XM-6KV3> (last visited Jan. 14, 2015) (offering both nonprofit and for-profit fund models); 13TH AVENUE FUNDING, <http://13thavenuefunding.org>, archived at <http://perma.cc/4QBY-MKC3>, (last visited Jan. 14, 2015).

8. See H.B. 3472, 77th Leg. Assemb., Reg. Sess. (Or. 2013) (directing consideration of a pilot “Pay Forward, Pay Back” program whereby students could opt to pay a proportion of their future income in lieu of present payment of tuition and fees); see also Martha C. White, *Oregon's 'Pay It Forward' Program: Imagine College with No Tuition, No Loans, No Debt* (Jul. 17, 2013), TIME.COM, <http://business.time.com/2013/07/17/oregons-pay-it-forward-program-imagine-college-with-no-tuition-no-loans-no-debt/>, archived at <http://perma.cc/5CKB-UVVF> (describing Oregon's income-based repayment plan specifically and various state income-based repayment plans generally).

9. See, e.g., *Bowie's Latest Hit: Royalty-Tied Bonds*, N.Y. TIMES, Feb. 21, 1997, at B5, available at <http://www.nytimes.com/1997/02/21/nyregion/bowie-s-latest-hit-royalty-tied-bonds.html>, archived at <http://perma.cc/WY3V-Z53N> (describing bonds paying interest from the royalties on certain David Bowie songs).

10. MILTON FRIEDMAN & SIMON KUZNETS, *Income in the Professions and in Other Pursuits*, in INCOME FROM INDEPENDENT PROFESSIONAL PRACTICE 90 n.20 (1945):

An individual will rarely sell a fixed proportion of his future income to an investor (i.e., he will rarely sell “stock” in himself), though he may borrow money . . . . On the other hand, if individuals sold “stock” in themselves, i.e., obligated themselves to pay a fixed proportion of future earnings, investors could “diversify” their holdings and balance capital appreciations against capital losses . . . . Such investments would be similar to others involving a large element of risk, a type of investment usually financed by stocks rather than bonds.

11. For a science-fiction examination of a world in which humans are incorporated at birth, see DANI KOLLIN & EYTAN KOLLIN, *THE UNINCORPORATED MAN* (2009).

12. For initial explorations of ISAs, see Oei & Ring, *supra* note 3; Schwartz, *supra* note 4.

The distinctiveness of ISAs paired with a desire for regulatory certainty has led to a nascent movement in favor of enacting overarching legal and regulatory schemes to govern them. For example, in April 2014, Senator Marco Rubio (R-FL) and former Representative Tom Petri (R-WI) introduced a bill, the “Investing in Student Success Act,” seeking to clarify the legality of ISAs and their treatment under securities, tax, bankruptcy, and usury laws.<sup>13</sup> Other commentators have also suggested a unified and consistent regulatory framework.<sup>14</sup>

This Article cautions against such an approach. It argues that a unified regulatory scheme may create as many problems as it solves. Despite their shared features, ISAs are heterogeneous and can resemble a variety of financial arrangements with which we are already familiar. New variations could also develop. Given their diversity, their resemblance to various preexisting categories, and the fact that we already have regulatory structures for such preexisting categories, the adoption of a new and unified regulatory scheme may cause economically similar transactions to be treated differently and ultimately may be over- or underinclusive or distortionary.

This Article argues instead that there are good reasons for making normative judgments and regulatory decisions about ISAs on a case-by-case basis by comparing and analogizing each new transaction to a more familiar arrangement (such as debt, corporate equity, servitude, insurance, or partnership interests) and by regulating it similarly to its closest analogue.<sup>15</sup> Each regulatory field should conduct this type of analysis in designing the treatment of ISAs. The process of comparison and analogy allows our experience with regulating similar transactions to guide our normative review of the new ISAs. In cases where a new transaction resembles, in substance, one for which there exists a clear set of rules, invention of a separate regulatory approach is likely to create unnecessary legal distinctions and distortions.<sup>16</sup> By

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13. H.R. 4436, 113th Cong. (2014). Although it died with the close of the 113th Congress, the Rubio-Petri Bill is an example of a unified approach and provides a benchmark for likely reform proposals.

14. See, e.g., MIGUEL PALACIOS, TONIO DESORRENTO & ANDREW P. KELLY, AMERICAN ENTERPRISE INSTITUTE, *INVESTING IN VALUE, SHARING RISK: FINANCING HIGHER EDUCATION THROUGH INCOME SHARE AGREEMENTS* (2014) (urging clarification of the legal treatment of ISAs in areas such as bankruptcy and tax); Schwartz, *supra* note 4 (manuscript at 6:59) (arguing that ISAs should be permitted and regulated under securities law and a complementary disclosure regime).

15. This approach is not unprecedented and has been employed in other contexts. See, e.g., Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 7 (2008) (using the analogy to physical products liability to build a case for consumer protection with respect to credit products).

16. See generally David Weisbach, *Line Drawing, Efficiency, and Doctrine in the Tax Law*, 84 CORNELL L. REV. 1627, 1631 (1999) (arguing in favor of drawing the most efficient—as opposed

contrast, “regulation by analogy”—identifying an existing transaction with which an ISA has the most similarities and regulating that ISA in a comparable fashion—would better avoid such regulatory discontinuities.

Regulation by analogy does have its risks. Some might argue that this approach could have a chilling effect on the ISA market due to outcome uncertainty in the treatment of any given transaction. However, this critique conflates regulatory certainty with substantive uniformity. While a comprehensive and uniform regime for ISAs might provide greater certainty for the covered transactions,<sup>17</sup> it would likely create significant and unnecessary legal distinctions and distortions as between ISAs and other economically similar transactions. On the flip side, it is possible to provide some regulatory certainty while doing regulation by analogy. This could be achieved, for example, by using narrowly tailored prototype guidance released by the relevant regulatory authorities, either in the form of regulations or rulings. Use of such carefully crafted safe harbors is a practice already familiar in a variety of regulatory fields.<sup>18</sup>

This Article suggests that regulation by analogy is best accomplished using a multifactor analysis to probe each transaction’s true economics. Our multifactor approach draws upon jurisprudence developed in tax and bankruptcy law, where courts have examined a

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to the most doctrinally significant—lines between transactions in the tax law context); Jeff Strnad, *Taxing New Financial Products: A Conceptual Framework*, 46 STAN. L. REV. 569, 570–71 (1994) (suggesting two analogical methods for assigning tax treatment to new financial arrangements); see also Bradley T. Borden, *Quantitative Model for Measuring Line-Drawing Inequity*, 98 IOWA L. REV. 971 (2013) (modeling inequity caused by line drawing); Yehonatan Givati, *Walking a Fine Line: A Theory of Line Drawing in Tax Law*, VA. TAX REV. (forthcoming 2015), available at <http://ssrn.com/abstract=2555254> (examining how lines are drawn in tax law).

17. See *infra* Part III.A (discussing the view that a single regime applied to a broad swath of ISAs would provide regulatory certainty, across many fields, to covered participants and proposing a case-by-case approach instead).

18. For example, Regulation D, promulgated by the Securities and Exchange Commission, provides a safe harbor from the onerous registration requirements for the issuance of certain securities. 17 C.F.R. §§ 230.501–08 (2014). Another example, from the federal tax law, was the provision of a safe harbor for certain leasing transactions. See MARGARET RILEY, INTERNAL REVENUE SERV., SAFE HARBOR LEASING, 1981 AND 1982 (1983), available at <http://www.irs.gov/pub/irs-soi/81-82sahale.pdf>, archived at <http://perma.cc/S2LB-SX32>:

[T]he new [1981] provisions guaranteed that a transaction would be recognized as a lease for Federal income tax purposes, regardless of existing IRS guidelines for determining whether a transaction is a lease, or merely a financing arrangement not subject to the same tax benefits, and also regardless of whether its nontax economic substance would otherwise be recognized as a true lease.

State-level regulators also employ safe harbor provisions. For example, Massachusetts regulations provide a safe harbor for manufacturers attempting to comply with state law handgun childproofing design requirements by listing several alternatives, which are deemed to meet the functional standard of the law. See 940 MASS. CODE REGS. § 16.05 (LexisNexis 2014).



number of relevant factors to distinguish lenders from firm owners in determining their appropriate treatment.<sup>19</sup> However, we envision that the application of the multifactor approach would differ depending on the legal regime doing the analysis, both in terms of the specific factors applied and the emphasis accorded to each factor. A multifactor approach allows us to examine the true economics of existing and future ISAs on a case-by-case basis, rather than arriving at universal conclusions regarding all ISAs. Although a broader, more unified regulatory framework for ISAs may become advisable down the road, uncertainties surrounding ISAs and their development suggest that the initial regulatory move should be one grounded in analogy.

Part II of this Article describes ISAs, discusses their historical antecedents, and explains how they relate to parallel developments in crowdfunding. Part III first explains why a case-by-case analysis that analogizes the ISAs to existing transactions is the superior approach for their evaluation and regulatory design. It then generally describes the universe of existing transactions to which ISAs are most analogous, focusing first on the analytical extremes of slavery or servitude, and debt, and then exploring the intermediate analytical possibilities. Part IV sets forth our multifactor framework for determining whether a given ISA is most analogous to debt, human ownership, or something else, and correspondingly how it should be regulated. Part V demonstrates the operation of our multifactor framework by applying it to Pave, a pioneer in ISA offerings. This Part then examines the Rubio-Petri proposed legislation as an illustration of the risks of an overarching regulatory approach.

The proposal for case-by-case analysis advocated herein is a second best solution, in the sense that it accepts as given the backdrop of existing regulations governing financial instruments, with all of their inconsistencies and imperfections. However, our proposed approach is ultimately sound; drafting a single, comprehensive regulatory regime for ISAs while deferring to existing regulatory regimes for other types of transactions would likely create unintended and inappropriate disjunctures and inefficiencies between the treatment of ISAs and other transactions. Our proposed approach avoids that pitfall.

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19. See, e.g., *Indmar Prods. Co. v. Comm'r*, 444 F.3d 771, 784 (6th Cir. 2006); *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 696 (3d Cir. 1968).

## II. THE TRANSACTIONS: CURRENT VARIANTS AND HISTORICAL ANTECEDENTS

The transactions discussed in this Article are not homogenous. Rather, their structures and economics vary, and they have arisen across a number of sectors. Part II.A provides an overview of the new ISAs.<sup>20</sup> Part II.B briefly describes their evolution and development. Part II.C discusses how ISAs relate to recent developments in crowdfunding and its regulation.

### A. *The New Income Share Agreements*

#### 1. Fantex, Inc.

As noted, Fantex is a trading platform that allows the public to acquire stock linked to the brand performance of professional football players.<sup>21</sup> As of April 2015, Fantex has commenced or announced stock offerings relating to the brand performance of Vernon Davis, a San Francisco 49ers tight end; E.J. Manuel, a Buffalo Bills quarterback; Mohamed Sanu, a Cincinnati Bengals wide receiver; Michael Brockers, a St. Louis Rams defensive tackle; and Alshon Jeffery, a Chicago Bears wide receiver.<sup>22</sup> It plans to undertake additional stock offerings in the future.

Underlying each offering is a contract between Fantex and the athlete, which provides that the athlete receives a lump-sum amount up front in exchange for a percentage of his future NFL-related income, including income earned from NFL contracts, endorsements, and appearance fees.<sup>23</sup> For example, in a \$4.2 million IPO, Vernon Davis received \$4 million from Fantex up front in exchange for a ten percent stake in his future NFL earnings.<sup>24</sup> Although Fantex is actually offering stock in Fantex, Inc., in a transaction technically distinct from the contract between Fantex and the athlete, the popular press has loosely

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20. In addition to the ISAs discussed herein, see ENZI, <http://www.enzi.org>, *archived at* <http://perma.cc/L989-XCLE> (last visited Mar. 25, 2015) (ISA structure for education funding); CUMULUS FUNDING, <http://www.cumulusfunding.com>, *archived at* <http://perma.cc/CZC2-FEWD> (last visited Mar. 25, 2015) (an ISA variant providing funds for “virtually any purpose”).

21. *See, e.g.*, Fantex, Inc., *supra* note 1.

22. *Explore Stocks*, FANTEX, <https://fantex.com/explore>, *archived at* <https://perma.cc/3G4D-K9JU> (last visited Apr. 2, 2015). The offering of Michael Brokers shares is pending while the others are currently trading. *Id.*

23. *See, e.g.*, Fantex, Inc., *supra* note 1 at 1, 97–100.

24. *Id.* at 6.

characterized the deal as an opportunity for stockholders to acquire shares in a football player.<sup>25</sup>

## 2. Upstart, Inc.<sup>26</sup>

In the entrepreneurial context, Upstart introduced in April 2012 a transaction that allowed potential investors to invest in individuals seeking funds for business or education costs. This model was available until May 6, 2014, when it was discontinued in favor of more traditional loan products, due in part to regulatory uncertainties.<sup>27</sup> However, agreements entered into between Upstart and funding recipients prior to May 6, 2014, presumably remain in effect.

In return for an upfront cash investment in the funding recipient, investors earned a specified percentage of the funding recipient's earnings for a set term, typically five years.<sup>28</sup> The underlying documentation was an agreement between Upstart (as a middleman) and the funding recipient, under which the recipient agreed to pay the investor (indirectly) the agreed percentage of recipient's total annual income as reported on her tax return (Line 22 of Form 1040)<sup>29</sup> over the specified term. Significantly, Line 22 includes not only wages and business income but also interest, dividends, alimony, and lottery

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25. See, e.g., Peter Lattman & Steve Eder, *Like That Athlete? Buy a Share*, N.Y. TIMES, Oct. 18, 2013, at A1 (“[N]ow, thanks to Wall Street, fans can buy a stake in their favorite player.”); see also Clarke, *supra* note 2 (suggesting in its headline that the stock is an investment in Arian Foster himself as opposed to Fantex's arrangement with Foster).

26. This description of Upstart's ISAs draws in part on our prior essay, Oei & Ring, *supra* note 3, at 269–70.

27. Dave Girouard, *Sunsetting Income Share Agreements on Upstart*, UPSTART BLOG, <http://blog.upstart.com/post/84980267394/sunsetting-income-share-agreements-on-upstart> (May 7, 2014), archived at <http://perma.cc/953B-SLTT>. Upstart noted that “while many regulatory and policy efforts are underway to facilitate the development of the market, these efforts will likely take many years.” *Id.*

28. See UPSTART FUNDING AGREEMENT § 5.a, available at [https://www.upstart.com/funding\\_terms](https://www.upstart.com/funding_terms), archived at <https://perma.cc/V4HA-J2UE> (last visited Jan. 15, 2015). Previously, a ten-year term was also available. See OCTOBER 2013 UPSTART FUNDING AGREEMENT § 5.a (on file with authors); see also Alison Griswold, *Upstart: Can Crowdfunding Your Education and Career Really Work?*, FORBES (Aug. 10, 2012, 5:48 PM), <http://www.forbes.com/sites/alisongriswold/2012/08/10/upstart-can-crowdfunding-your-education-and-career-really-work/2/>, archived at <http://perma.cc/E45A-WRJ5> (“Upstart estimates that typical students will raise around \$30,000 in exchange for 2 to 6% of their 10-year income . . .”).

29. See UPSTART FUNDING AGREEMENT, *supra* note 28, § 2.a.i. Upstart interposed a grantor trust between the investors and the recipient. See *Who is Upstart Network Trust?*, (Apr. 29, 2014) (on file with authors). Upstart entered into the funding agreement with the recipient and then transferred that agreement to the Trust (where it became a Trust asset). See *id.* The Trust issued securities to investors in exchange for funds that were used to pay the recipient. *Id.* The Trust securities were secured by the funding agreements and investors only received payment to the extent the recipient paid the Trust. *Id.*; see also *How Are the Securities Treated for U.S. Federal Income Tax Purposes?* (Apr. 29, 2014) (on file with authors).

winnings (that is, any income regardless of any connection to the activity or venture for which funding was sought).<sup>30</sup>

The risk to the investors was partially mitigated by the funding agreement's deferral provision, which deferred the annual payments and added a year to the contract term if the recipient's income for the year fell below a preestablished threshold.<sup>31</sup> A funding recipient could obtain up to five such deferrals, after which she was obligated to pay the income share for the remainder of the now-extended contract term.<sup>32</sup> The "risk" of the recipient's extraordinary success was capped by limiting the total income payment to three times the amount of funding received.<sup>33</sup>

As of this writing, Upstart has started offering fixed-rate loan products.<sup>34</sup> Upstart continues to distinguish their loans from more traditional loan products on the grounds that their model incorporates factors such as educational institution attended, academic area of study, academic performance, and employment history in determining the applicable interest rate.<sup>35</sup>

### 3. Pave<sup>36</sup>

Along with Upstart, Pave is another startup that commenced offering ISAs in 2012.<sup>37</sup> Pave has never been as open as Upstart in making its deal documents public, and the actual deal documents are only available to investors and funding seekers upon creation of an

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30. INTERNAL REVENUE SERV., OMB NO. 1545-0074, FORM 1040: U.S. INDIVIDUAL INCOME TAX RETURN 1 IL 7–22.

31. UPSTART FUNDING AGREEMENT, *supra* note 28, § 2.b.i.

32. *Id.* The 2013 Agreement also included a hardship exemption for years in which the recipient's income dropped below \$20,000, even if the contract had previously been deferred five times for low earnings. No additional contract extension would be made in such circumstances. OCTOBER 2013 UPSTART FUNDING AGREEMENT, *supra* note 28, § 2.b.ii.

33. UPSTART FUNDING AGREEMENT, *supra* note 28, § 2.c. In the 2013 Agreement, which offered the option of a ten-year contract, the cap was five times the funding amount in the case of a ten-year agreement. OCTOBER 2013 UPSTART FUNDING AGREEMENT, *supra* note 28, § 2.c.

34. *What is Upstart?*, UPSTART, <http://upstarthelp.upstart.com/questions/108556-what-is-upstart>, archived at <http://perma.cc/7J2F-V5U8> (last visited, Jan. 15, 2015).

35. *Id.*; see also *Am I Eligible to Apply for a Loan?*, UPSTART, <http://upstarthelp.upstart.com/questions/108498-am-i-eligible-to-apply-for-a-loan>, archived at <http://perma.cc/Z25M-GZYG> (last visited Jan. 15, 2015).

36. The Pave transaction is governed by an Income-Linked Payment Agreement ("IPA"), which is not publicly available. *Invest Where It Matters Most to You*, PAVE, <https://www.pave.com/introduction/backer>, archived at <http://perma.cc/4MGG-SUDH> (last visited Jan. 15, 2015). See sources cited *infra* notes 38–48 for information details regarding Pave's ISA.

37. See Hadley Malcom, *Pave: Alternative to Costly College Loans*, USA TODAY, Mar. 5, 2013, <http://college.usatoday.com/2013/03/05/pave-alternative-to-costly-college-loans/>, archived at <http://perma.cc/7ZXY-ERMS> (noting Pave's initial ISAs were offered in December 2012).

account with Pave.<sup>38</sup> Furthermore, as the market for ISAs has developed, Pave has made less and less information publicly available on its website, so it is difficult to know the exact economics of the instruments currently being offered. The following summary is based on information that was available on Pave's website as of May 2014.<sup>39</sup>

Pave's strategy (as of May 2014)<sup>40</sup> was to target millennials and "high potential individuals" seeking funding for a variety of purposes, including to pay off student loans, to finance education, or to pursue entrepreneurial ventures.<sup>41</sup> Like Upstart, the Pave transaction allows funding seekers ("Talent") to obtain funding by promising to pay investors ("Backers") a fixed percentage (no more than ten percent) of their annual Line 22 total income over a specified term, which may not exceed ten years.<sup>42</sup> However, unlike Upstart, the Pave arrangement is "peer-to-peer."<sup>43</sup> The average amount raised is \$20,000.<sup>44</sup>

If Talent's income falls below 150 percent of the poverty line, repayment obligations are waived, and the payment term is not extended.<sup>45</sup> If Talent is in school, repayment obligations also cease, but

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38. See PAVE, *supra* note 6.

39. Much of the publicly available information has since been removed from the website, so it is difficult to know the extent to which the economics of the Pave structure have changed since then. However, as was the case with Upstart, agreements already entered into between Pave's investors and funding seekers presumably remain in effect.

40. See *infra* note 50 and accompanying text.

41. See *How Can the Funds I Raise Be Used?*, PAVE, <http://support.pave.com/hc/en-us/articles/200917846-How-can-the-funds-I-raise-be-used-> (May 19, 2014) (on file with authors); *Financial Assistance for Millennials*, PAVE, <http://www.pave.com/financial-assistance-millennials> (May 19, 2014) (on file with authors).

42. *How Much of My Income Will I Share with Backers?*, PAVE, <http://support.pave.com/hc/en-us/articles/200407638-How-much-of-my-income-will-I-share-with-Backers-> (May 19, 2014) (on file with authors). If Talent is filing a joint return, the spouse's income is deducted from Line 22 income. *What Counts as Income When Calculating How Much I Must Share with My Backers?*, PAVE, <http://support.pave.com/hc/en-us/articles/200407688-What-counts-as-income-when-calculating-how-much-I-must-share-with-my-Backers-> (May 19, 2014) (on file with authors).

43. *Tell Me More About Pave's Income-Linked Payment Agreement (IPA)*, PAVE, <http://support.pave.com/hc/en-us/articles/200990453-Tell-me-more-about-Pave-s-Income-linked-Payment-Agreement-IPA-> (May 19, 2014) (on file with authors).

44. *How Much Funding Can I Raise?*, PAVE, <http://support.pave.com/hc/en-us/articles/200848547-How-much-funding-can-I-raise-> (May 19, 2014) (on file with authors). Pave collects certain fees. *What Are Pave's Fees?*, PAVE, <http://support.pave.com/hc/en-us/articles/200597893-What-are-Pave-s-fees-> (May 19, 2014) (on file with authors).

45. *Is There Ever a Time During the Participation Period When I Wouldn't Need to Share Income?*, PAVE, <http://support.pave.com/hc/en-us/articles/200407668-Is-there-ever-a-time-during-the-participation-period-when-I-wouldn-t-need-to-share-income-> (May 19, 2014) (on file with authors). In this, Pave is different from Upstart, because Upstart's hardship exemption does extend the payment term. UPSTART FUNDING AGREEMENT, *supra* note 28, § 2.b.i.

the repayment term is extended.<sup>46</sup> Talent can terminate the agreement early by paying Backers five times the original funding amount, which effectively caps the maximum repayment.<sup>47</sup> The payment terms are determined for each individual based on Pave's proprietary funding model, which is designed to provide investors with a seven percent rate of return.<sup>48</sup> While Pave's transaction resembles Upstart's, there are structural, economic, and "soft" differences between them, which may require different approaches to regulation.<sup>49</sup> In August 2014, Pave announced that it would be piloting a new loan product.<sup>50</sup> However, it is unclear whether that new product is in addition to, or in replacement of, the ISA that Pave had previously been offering. In any event, the Pave ISA continues to be relevant as a market leading ISA into which Talent and Backers have entered.

#### 4. Education-Based Transactions

The income share concept has also permeated the higher education context, driven in part by rising education costs and the search for alternative financing solutions. As the following discussion demonstrates, education-focused ISAs have been offered by for-profit, nonprofit, and government entities.<sup>51</sup>

##### *a. Lumni*

Lumni manages funds that invest in "diversified pools of students."<sup>52</sup> Funding providers invest in a fund, which may be either for-profit or nonprofit, and the fund finances the students' educations.<sup>53</sup> Instead of repaying principal and interest, students repay the fund a

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46. *Is There Ever a Time During the Participation Period When I Wouldn't Need to Share Income?*, *supra* note 45.

47. *Can Talent Exit the Pave IPA Early?*, PAVE, <http://support.pave.com/hc/en-us/articles/200478356-Will-I-be-able-to-exit-the-Pave-IPA-early-> (May 19, 2014) (on file with authors).

48. *Our Model*, PAVE, <http://www.pave.com/funding-model>, *archived at* <http://perma.cc/R33Z-SR5N> (last visited Feb. 14, 2015); *What are the Expected Financial Returns?*, PAVE <http://support.pave.com/hc/en-us/articles/200678278-What-are-the-expected-financial-returns-> (May 19, 2014) (on file with authors).

49. *See infra* Part V.

50. *Introducing the Pave Loan: A Letter from Our Founders* (Aug. 14, 2014), <http://blog.pave.com/post/94752393200/introducing-the-pave-loan-a-letter-from-our>, *archived at* <http://perma.cc/NQ7D-TH5T>. Portions of the Pave website continue, as of March 25, 2015, to refer to the income-linked payment agreements, Pave's ISA. *See* PAVE, <https://www.pave.com/introduction/backer>, *archived at* <http://perma.cc/GZZ9-5JQH> (last visited March 25, 2015). Presumably existing ISAs remain active, continuing to run through to term (up to ten years).

51. *See also* ENZI, *supra* note 20.

52. *About Lumni*, *supra* note 7.

53. *Id.*

fixed percentage of future income for ten years after graduation, and the fund distributes a return to the investor.<sup>54</sup> Lumni characterizes its structure as a “win-win partnership” between students and investors.<sup>55</sup>

Lumni launched in Chile in 2002 and since then has expanded to Colombia, Peru, Mexico, and the United States.<sup>56</sup> Thus, unlike the other market participants, Lumni originated overseas and has been in operation for a number of years.<sup>57</sup> Lumni also works with corporations that fund the education of children of employees and distributors, though it is unclear whether any of these ventures have launched in the United States to date.<sup>58</sup>

Lumni is the brainchild of Professor Miguel Palacios.<sup>59</sup> Building on Milton Friedman’s work,<sup>60</sup> Palacios has argued that human capital contracts are a superior way of funding higher education because they reduce risk for students, improve information and decisionmaking regarding the value of education, and increase competition in the higher education market.<sup>61</sup> Lumni reflects Palacios’s underlying vision.

### *b. 13th Avenue Funding*

13th Avenue Funding is a nonprofit that fosters community-based education funding programs.<sup>62</sup> Like Lumni, 13th Avenue’s system funds education by requiring students to pay a percentage of future income, rather than repay the original loan through a fixed

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54. *Id.*

55. *Id.*; *For Students*, LUMNI, <http://www.lumni.net/forstudents/>, archived at <http://perma.cc/Q4MK-T7GV> (last visited Jan. 16, 2015).

56. LUMNI, *supra* note 7; *Our Story*, LUMNI, <http://www.lumniusa.net/about/our-story>, archived at <http://perma.cc/XX3L-HL74> (last visited Jan. 26, 2015).

57. Since 2009, Lumni has funded twenty-seven U.S. students. Kate Bachelder, *Escaping the Student Debt Trap*, WALL ST. J., June 13, 2014, <http://www.wsj.com/articles/the-weekend-interview-escaping-the-student-debt-trap-1402699281>. It has funded almost five thousand students total since 2002. *Id.*; see also LUMNI, *supra* note 7; *Our Story*, *supra* note 56.

58. *For Corporations*, LUMNI, <http://www.lumni.net/forcorporations>, archived at <http://perma.cc/5P4M-86PT> (last visited Jan. 16, 2015).

59. See MIGUEL PALACIOS LLERAS, *INVESTING IN HUMAN CAPITAL* (2004); Miguel Palacios, *Human Capital Contracts: “Equity-like” Instruments for Financing Higher Education*, POL’Y ANALYSIS No. 462, Dec. 16, 2002, available at <http://lumni.net/about/palacios.pdf>, archived at <http://perma.cc/87HB-5AJV>; see also PALACIOS, DESORRENTO & KELLY, *supra* note 14, at 1.

60. See, e.g., MILTON FRIEDMAN, *CAPITALISM AND FREEDOM* (1962); see also Friedman & Kuznets, *supra* note 10, at 90 n.20 (noting that “if individuals sold ‘stock’ in themselves, i.e., obligated themselves to pay a fixed proportion of future earnings, investors could ‘diversify’ their holdings and balance capital appreciations against capital losses”).

61. PALACIOS LLERAS, *supra* note 59, at xviii; PALACIOS, DESORRENTO & KELLY, *supra* note 14; Palacios *supra* note 59, at 1.

62. 13TH AVENUE FUNDING, *supra* note 7.

monthly amount.<sup>63</sup> However, 13th Avenue's model is distinctive because the financing relationship is local: funding providers invest in members of the same community.<sup>64</sup> Thus, 13th Avenue's model may bear a stronger resemblance to informal funding arrangements among friends and family than might be the case with some other ISAs.

Founded in 2009, 13th Avenue piloted its program at Allan Hancock College in Santa Maria, California.<sup>65</sup> It hopes that its funding model can be extrapolated for use by other local community groups. To that end, 13th Avenue has made its deal documents publicly available for free use under a creative commons license, together with instructions for how to create one's own "college financing community" in other local communities.<sup>66</sup>

### *c. Leff-Hughes Swap Transaction*

In another variation on the ISA concept, Professors Benjamin Leff and Heather Hughes have proposed an income-based rate swap ("IBR swap") as a mechanism for financing legal education.<sup>67</sup> Under this proposal, the student would still borrow from the government or banks to finance their legal education.<sup>68</sup> But then the student would enter into a contract with a financial institution under which that financial

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63. See *id.* Payment is not required if the student is out of work. *Id.*

64. *Id.*; see also Rick Cohen, *A Venture Capital Model to Pay for College Student Loans*, NONPROFIT Q. (Aug. 6, 2013, 3:18 PM), available at <https://nonprofitquarterly.org/policysocial-context/22709-a-venture-capital-model-to-pay-for-college-student-loans.html>, archived at <http://perma.cc/ZZ7T-935E> ("[T]he 13th Avenue concept is meant to help first-generation immigrant college students and low-income students."); Laura Matthews, *Student Loan Debt Crisis: A New Nonprofit 13th Avenue Wants an America Without College Loans*, INT'L BUS. TIMES, Aug. 2, 2013, available at <http://www.ibtimes.com/student-loan-debt-crisis-new-nonprofit-13th-avenue-wants-america-without-college-loans-1366729>, archived at <http://perma.cc/L584-9U5Q> (describing 13th Avenue's focus on community building and "pay[ing] it forward").

65. *Our Pilot Program*, 13TH AVENUE FUNDING, <http://13thavenuefunding.org/styled/index.html>, archived at <http://perma.cc/6F99-FN92> (last visited Feb. 12, 2015); see Matthews, *supra* note 64.

66. *How to Build Your Own College Financing Community*, 13TH AVENUE FUNDING, <http://13thavenuefunding.org/styled-2/index.html>, archived at <http://perma.cc/UTP8-STM3> (last visited Feb. 12, 2015). 13th Avenue has made available on its website sample contracts between (1) the sponsoring community organization and the student and (2) the sponsoring organization and the funding provider. *The Documents*, 13TH AVENUE FUNDING, <http://13thavenuefunding.org/styled-5/index.html>, archived at <http://perma.cc/3NKQ-GY9D>, (last visited Jan. 22, 2015).

67. Benjamin M. Leff & Heather Hughes, *The Income-Based Repayment Swap: A New Method for Funding Law School Education* (Jul. 9, 2013) (unpublished paper), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2291714](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2291714); see also Jacob Gershman, *Placing Bets on Law School Graduates*, WALL ST. J.L. BLOG (July 19, 2013, 3:57 P.M.), <http://blogs.wsj.com/law/2013/07/19/placing-bets-on-law-school-graduates/>.

68. Leff & Hughes, *supra* note 67, at 11–19 (describing the IBR swap).



institution would assume responsibility for making the student's law school loan repayments.<sup>69</sup> In exchange, the student would agree to pay the financial institution a percentage of her future earnings over a fixed time period.<sup>70</sup> The financial institution would make a profit when a student ends up in a high-paying job (e.g., Biglaw partner) but would experience a loss on students who do not find employment or who enter low-paying jobs. Leff and Hughes argue that the IBR swap contains the benefits of more traditional ISAs or human capital contracts but can help reduce the legal and regulatory barriers associated with ISAs.<sup>71</sup> They do note, however, that the IBR swap may also create adverse selection and moral hazard problems and may create inequities in student admissions and financial aid decisions.<sup>72</sup>

#### *d. Government Income-Contingent Repayment Plans*

The income sharing concept has found its way into the government-provided higher education funding sector as well. Responding to rising student debt loads, the U.S. government introduced in 2009 a federal income-based repayment ("IBR") program for education loans, which permitted qualifying students to cap repayments on eligible student loans at fifteen percent of discretionary income.<sup>73</sup> Payments would be made monthly for twenty-five years, after which the loan would be forgiven.<sup>74</sup> For qualifying new borrowers on or after July 1, 2014, the repayment percentage dropped to ten percent, and the repayment term dropped to twenty years.<sup>75</sup> The government also introduced the Pay As You Earn (or "PAYE") plan in 2012 for

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69. *Id.*

70. *Id.*

71. *Id.* at 19–50.

72. *Id.* at 50–58.

73. *See Income-Driven Plans*, FED. STUDENT AID, <https://studentaid.ed.gov/repay-loans/understand/plans/pay-as-you-earn#monthly-payments>, archived at <http://perma.cc/HB9R-SWVS> (last visited Jan. 16, 2015) (summarizing income-driven repayment plans). Discretionary income is, generally, adjusted gross income minus 150 percent of the poverty line. *Glossary*, FED. STUDENT AID, [https://studentaid.ed.gov/glossary#Discretionary\\_Income](https://studentaid.ed.gov/glossary#Discretionary_Income), archived at <http://perma.cc/RJ8X-PLHP> (last visited Jan. 18, 2015); *see also* College Cost Reduction and Access Act, Pub. L. No. 110-84, § 203, 121 Stat. 784, 792–94 (2007) (codified at 20 U.S.C. § 1098e (2012) (income-based repayment)). *See generally* John R. Brooks II, *Income-Based Repayment and the Public Financing of Higher Education* (Oct. 20, 2014) (unpublished paper), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2513359](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2513359) (examining and evaluating IBR's tax-like characteristics).

74. *Income-Driven Plans*, *supra* note 73. Under current tax law, this would give rise to cancellation of debt income. I.R.C. § 108 (2012). *See Income-Driven Plans*, *supra* note 73 (noting that "you may be required to pay income tax on any amount that is forgiven . . ."). *But see* I.R.C. § 108(f) (exception for student loans where individual works for certain employers).

75. *Income-Driven Plans*, *supra* note 73.

qualified new borrowers.<sup>76</sup> PAYE caps payments at ten percent and forgives the debt after twenty years.<sup>77</sup> For students holding public service jobs, any remaining debt on Direct Loans under IBR, PAYE, or another income-driven repayment plan is cancelled after 120 qualifying payments.<sup>78</sup>

These plans share two features: the student's monthly loan payment is capped, and students are eligible only if the income-contingent payment is less than what they would have to pay under the standard student loan repayment plan. Thus, unlike the private sector models, these income-contingent plans hold no upside for the government. It has been pointed out that the government may actually be outcompeting the private market for ISAs in providing income-based repayment plans with no upside.<sup>79</sup>

#### *e. State-Based Alternatives*

Finally, states have also begun exploring creative education financing alternatives. In 2013, Oregon passed a bill directing the Oregon Higher Education Coordinating Commission ("HECC") to consider the creation of a new pilot program under which students attending Oregon state colleges and universities would not pay tuition but instead a percentage of their income for a certain time period.<sup>80</sup> The bill did not establish payment percentages or durations.<sup>81</sup> The proposed pilot design was created in September 2014.<sup>82</sup> In its transmittal letter to the Oregon legislature, the HECC noted that this "Pay It Forward" pilot was "a worthy initiative for the Oregon Legislature to undertake, subject to the availability of funding over and above [the Legislature's]

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76. 34 C.F.R. § 685.209 (2014). "New borrowers" are borrowers who did not owe money on a federal student loan as of October 1, 2007, and received a Direct Loan disbursement on or after Oct. 1, 2011. *Id.*

77. *Id.*; *Income-Driven Plans*, *supra* note 73.

78. *Income-Driven Plans*, *supra* note 73; *Public Service Loan Forgiveness*, FED. STUDENT AID, <https://studentaid.ed.gov/repay-loans/forgiveness-cancellation/charts/public-service>, *archived at* <http://perma.cc/2ZDS-VD8T> (last visited Jan. 17, 2015).

79. See Megan McArdle, *When Education Doesn't Pay*, BLOOMBERGVIEW (May 13, 2014, 2:27 P.M.) <http://www.bloombergview.com/articles/2014-05-13/when-education-doesn-t-pay>, *archived at* <http://perma.cc/WCH3-989K>.

80. See White, *supra* note 8; see also PAY IT FORWARD WORKGROUP, HOUSE BILL 3472: PAY IT FORWARD (2014) *available at* <http://education.oregon.gov/Documents/HECC/Student%20Success/8-13-14/PIF%20Report%20Draft%208-7-14d.pdf>, *archived at* <http://perma.cc/VW65-M7VK> (draft report).

81. H.B. 3472, 77th Legis. Assemb., Reg. Sess. (Or. 2013).

82. HIGHER EDUC. COORDINATING COMM'N, HOUSE BILL 3472: PAY IT FORWARD, 1–2 (2014), *available at* <http://library.state.or.us/repository/2014/201410231424054/>.

core investment priorities.”<sup>83</sup> The HECC recommended that the pilot program be undertaken provided that certain funding and other conditions are met.<sup>84</sup> Other states are looking into comparable legislative options, and proposed federal legislation in the 113th Congress would have directed feasibility studies and matching grants at the federal level (among other recommendations).<sup>85</sup>

### *B. Related Economic Arrangements*

ISAs clearly represent a new wave of human capital interactions, but in some respects they resemble arrangements that have existed in the past or are operating today.<sup>86</sup> At a most basic level, families and communities have long invested informally in their youth in exchange for reciprocal repayments in the future. Assisted by technology platforms, however, such income sharing is now occurring on a larger scale and with more formalization. This shift demands a more robust legal and normative analysis. Before undertaking that analysis, however, it is useful to survey historical antecedents and related present-day transactions in order to situate ISAs in context.

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83. Letter from Higher Educ. Coordinating Comm'n to Legislator (Sept. 24, 2014) available at [http://education.oregon.gov/Documents/HECC/Reports%20and%20Presentations/HECCTransmissionLetterPIF.pdf?Mobile=1&Source=%2F\\_layouts%2Fmobile%2Fdispform%2Easp%3FList%3Dfb51bf5d-4277-431c-8e43-d3c923ec0a13%26View%3D123a0c05-35ed-4887-aef0-3a43aa5b0fc9%26RootFolder%3D%252FDocuments%252FHECC%252FReports%2520and%2520Presentations%26ID%3D785%26CurrentPage%3D1](http://education.oregon.gov/Documents/HECC/Reports%20and%20Presentations/HECCTransmissionLetterPIF.pdf?Mobile=1&Source=%2F_layouts%2Fmobile%2Fdispform%2Easp%3FList%3Dfb51bf5d-4277-431c-8e43-d3c923ec0a13%26View%3D123a0c05-35ed-4887-aef0-3a43aa5b0fc9%26RootFolder%3D%252FDocuments%252FHECC%252FReports%2520and%2520Presentations%26ID%3D785%26CurrentPage%3D1), archived at <http://perma.cc/F39W-LBPU> (transmission letter to HECC report).

84. See HIGHER EDUC. COORDINATING COMM'N, *supra* note 82, at 9.

85. H.R. 3959, 113th Cong. (as introduced in the house Jan. 29, 2014); Thomas L. Harnisch, *The "Pay It Forward" College Financing Concept: A Pathway to the Privatization of Public Higher Education*, POLY MATTERS, July 2014, at 4, available at <http://www.aascu.org/policy/publications/policy-matters/PayItForward.pdf>, archived at <http://perma.cc/9682-7MK2> (describing status of similar legislation in various states); ECONOMIC OPPORTUNITY INSTITUTE, PAY IT FORWARD: AN UPDATE ON NATIONAL PROGRESS, (2014), <http://www.eoionline.org/wp/wp-content/uploads/Update-on-national-progress1.pdf>, archived at <http://perma.cc/9C8N-D39W> (reviewing status of legislative efforts underway in other states); see also AN ANALYSIS OF THE FEASIBILITY OF AN ILLINOIS PAY IT FORWARD PROGRAM, AS DIRECTED BY PUBLIC ACT 98-920, REPORT TO THE ILLINOIS GENERAL ASSEMBLY, <http://www.isac.org/dotAsset/1b1c678e-6a2e-463c-bfaa-f3265d9c87ec.pdf>.

86. Friedman & Kuznets, *supra* note 10, at 90 n.20; see also Bas Jacobs & Sweder J.G. van Wijnbergen, *Capital-Market Failure, Adverse Selection, and Equity Financing of Higher Education*, 63 FINANZARCHIV: PUB. FIN. ANALYSIS 1, 5 (2007) (reviewing the challenges of using human capital contracts); J.R. Walsh, *Capital Concept Applied to Man*, 49 Q.J. ECON. 255, 256 (1935) (examining “whether money spent in acquiring such training is, in a strict sense, a capital investment made in a profit-seeking, equalizing market, in response to the same motives which lead to the creation of factories, machinery, and the like”).

## 1. Portland's "IPO Man"

In a parallel yet idiosyncratic development, at least one individual has created "shares" in himself and sold them to investors.<sup>87</sup> Mike Merrill of Portland, Oregon, commenced this share offering in 2008, and the shares are outstanding to this day.<sup>88</sup> Merrill shares can be bought and traded on his personal stock exchange and are owned by friends, family, and strangers.<sup>89</sup> The shares are not backed by a company and are a high-risk investment.<sup>90</sup> Merrill's own website states that the investment is not safe.<sup>91</sup> In fact, the website describes the ownership of Merrill shares as "just a metaphor for trust" and as a "personal decision-making engine modeled after a stock market" that "measure[s] influence as the number of shares a person has."<sup>92</sup>

As a result of this stock offering, Merrill has experienced competing shareholder interests, stock price manipulation, and investors' decisions at the expense of his well-being.<sup>93</sup> Ever since a shareholder complained about not being consulted when Merrill moved in with his then-girlfriend<sup>94</sup>—a decision that could impact his creative output and put investor capital at risk—Merrill has allowed shareholders to vote on various matters affecting his personal life. To date, shareholders have decided (1) whom Merrill should date, (2) that he must register as a Republican, (3) that he should become a vegetarian, (4) that he should stop sleeping through the night, and (5) that he should not get a vasectomy.<sup>95</sup> In addition to voting rights, each share generates a potential return on profits earned outside of Merrill's day job.<sup>96</sup> Merrill's shareholders have also approved a motion

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87. Joshua Davis, *Meet the Man Who Sold His Fate to Investors at \$1 a Share*, WIRED (Mar. 28, 2013), <http://www.wired.com/2013/03/ipo-man/>, archived at <http://perma.cc/HE26-G5MR>; Rob Walker, *How One Man Turned Himself into a Publicly Owned Company*, ATLANTIC, April 2013, <http://www.theatlantic.com/magazine/archive/2013/04/putting-the-i-in-ipo/309255/>, archived at <http://perma.cc/FEW6-DPXG>.

88. See Davis, *supra* note 87.

89. See Walker, *supra* note 87; see also KMIKEYM, [www.KmikeyM.com](http://www.KmikeyM.com), archived at <http://perma.cc/XR4T-NEUM> (last visited Jan. 18, 2015) (exchange for shares in Merrill).

90. See *About*, KMIKEYM, <http://urbanhonking.com/kmikeym/about/>, archived at <http://perma.cc/UE2K-GLVW> (last visited Jan. 18, 2015).

91. *Id.*; see also Nicole Goodkind, *Human IPO: Man Sells Himself for \$10,000*, YAHOO! FIN. (Apr. 22, 2013, 8:10 A.M.), <http://finance.yahoo.com/blogs/daily-ticker/sell-yourself-10-000-135455858.html>, archived at <http://perma.cc/TQ6D-8PVW> (share issuance not legally binding).

92. *About*, *supra* note 90.

93. See Davis, *supra* note 87.

94. See Walker, *supra* note 87.

95. Davis, *supra* note 87.

96. *Id.*

that, in the event of Merrill's death, his life insurance proceeds would be distributed among themselves.<sup>97</sup>

Although the Merrill transaction may seem more like reality television than a serious financial investment, it is a useful reminder of the range of structuring possibilities in today's technological environment, the power that investors can have over a person's decisions, the potential consequences of applying the share economy to an individual, and the uncertainty surrounding the regulation of equity-like investments in people.

## 2. Baseball Buscones

ISAs have also been compared to various athlete-agent relationships, particularly in professional baseball recruitment but in other professional sports contexts as well.<sup>98</sup> With respect to professional baseball, MLB teams have historically profited by cheaply signing Caribbean-born players.<sup>99</sup> While Major League Rules require North American and Puerto Rican players to enter the First-Year Player Draft, international players are exempt.<sup>100</sup> Thus, there are few restrictions on how they are recruited and signed.<sup>101</sup>

The absence of regulation has spawned an industry of local street agents known as *buscones*.<sup>102</sup> Buscones promise to develop the talent of young boys until they are eligible to sign with an MLB team, providing training, food, lodging,<sup>103</sup> and representation.<sup>104</sup> In exchange, the buscone gets a percentage (often between ten and thirty percent) of

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97. *Id.*

98. See Rob Ruck, *Baseball's Recruitment Abuses*, AMERICAS Q., Summer 2011, <http://americasquarterly.org/node/2745>, archived at <http://perma.cc/RML2-HDHB> (describing the relationships between athletes and their agents).

99. Kevin Baxter, *Dominican Shift*, L.A. TIMES, Apr. 15, 2008, <http://articles.latimes.com/2008/apr/15/sports/sp-dominicans15>, archived at <http://perma.cc/J78P-MNM2> (discussing how signing bonuses for players from the Dominican Republic were beginning to increase after many years of extremely low payments); Ruck, *supra* note 98 (describing how signing bonuses have spiraled to an average of about \$131,000 in 2011 compared to an average of \$2,000–\$5,000 in 1990).

100. Ruck, *supra* note 98; see 2012–2016 BASIC AGREEMENT BETWEEN MAJOR LEAGUE CLUBS AND MAJOR LEAGUE BASEBALL PLAYERS ASSOCIATION, attachment 46, § I, available at [http://mlb.mlb.com/pa/pdf/cba\\_english.pdf](http://mlb.mlb.com/pa/pdf/cba_english.pdf), archived at <http://perma.cc/M3LL-L2J4> (explaining the potential for addition of an international players draft).

101. Ruck, *supra* note 98.

102. Most MLB teams today rely on buscones. Baxter, *supra* note 99.

103. Ruck, *supra* note 98.

104. Sean Gregory, *Baseball Dreams: Striking Out in the Dominican Republic*, TIME, July 26, 2010, <http://content.time.com/time/magazine/article/0,9171,2004099-1,00.html>, archived at <http://perma.cc/Y9WC-AN65>.

the signing bonus if the player signs professionally.<sup>105</sup> Though primarily active overseas, buscone relationships have occurred domestically as well.<sup>106</sup>

The growth in the buscone industry has arguably improved prospects' ability to negotiate with MLB teams, driving signing bonuses higher.<sup>107</sup> But it has also created ethical issues leading the MLB to investigate<sup>108</sup> exploitation, discontinuation of schooling, provision of performance enhancing drugs, age misrepresentation, and overcrowded and substandard training facilities.<sup>109</sup>

The story of buscones holds a cautionary tale for ISAs. Individuals with limited current options but some future potential may have no choice but to promise a cut of their future earnings in order to improve their chances of securing that successful future. But monetization of future human capital may lead to exploitation, given power imbalances and information asymmetries. The question, then, is how the benefits of ISAs should be weighed against their potential risks.

### 3. Bowie Bonds

Parallels may also be drawn between so-called "Bowie Bonds" and the new ISAs. In 1997, David Bowie became the first musician to securitize his intellectual property rights in a bond offering.<sup>110</sup> Bowie

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105. Jorge L. Ortiz, *Exploitation, Steroids Hitting Home in Dominican Republic*, USA TODAY, Mar. 26, 2009, [http://usatoday30.usatoday.com/sports/baseball/2009-03-26-dominican-republic-cover\\_N.htm?csp=Forbes](http://usatoday30.usatoday.com/sports/baseball/2009-03-26-dominican-republic-cover_N.htm?csp=Forbes), archived at <http://perma.cc/6N8A-Y9JP>; Ruck, *supra* note 98.

106. Kyle Finck & Christian Red, 'Buscones', or Street Agents, Shape Young Baseball Talent . . . for a Price, DAILY NEWS, Aug. 1, 2010, <http://www.nydailynews.com/sports/baseball/buscones-street-agents-shape-young-baseball-talent-price-article-1.465231>, archived at <http://perma.cc/X26C-2SYT>.

107. In 1990, MLB teams signed three hundred Dominican prospects for an average bonus of \$2,500. In the first four months of 2011, MLB signed 188 Dominican prospects for an average of about \$131,000. Ruck, *supra* note 98.

108. Michael S. Schmidt, *Baseball Emissary to Review Troubled Dominican Pipeline*, N.Y. TIMES, Mar. 10, 2010, [http://www.nytimes.com/2010/03/11/sports/baseball/11dominican.html?\\_r=0](http://www.nytimes.com/2010/03/11/sports/baseball/11dominican.html?_r=0), archived at <http://perma.cc/THY9-TKFJ>; Ruck, *supra* note 98; see 2012–2016 BASIC AGREEMENT, *supra* note 100, art XII (discipline rules).

109. See Gregory, *supra* note 104; Ruck, *supra* note 98; Schmidt, *supra* note 108. See generally Manuel Jimenez, *Miami Doping Scandal Casts Pall over Dominican Baseball*, REUTERS, (Aug. 8, 2013) available at <http://www.reuters.com/article/2013/08/18/us-baseball-doping-dominican-idUSBRE97H05920130818>, archived at <http://perma.cc/2MMH-SFEF> (observing that up to ninety-eight percent of Dominican prospects do not make it to the major leagues). Prospects who do not make it to the major leagues return to the Dominican Republic without the education or skills necessary to enter the workforce. Gregory, *supra* note 104.

110. Michael R. McCabe, *You Have Now Entered the Bowie Bond Era*, SECONDARY MORTGAGE MARKET, July 1997, <http://www.freddiemac.com/finance/smm/july97/pdfs/mccabe.pdf>, archived at <http://perma.cc/Y9P2-MNYJ>.

issued bonds in order to accelerate payment of royalties from his music.<sup>111</sup> Bowie sold certain catalogue rights, including the rights to future royalty payments, to a bankruptcy-remote special purpose vehicle (“SPV”).<sup>112</sup> Borrowing against future royalty income, the SPV raised \$55 million.<sup>113</sup> The SPV repaid its lender the principal plus 7.9 percent annual interest for a period of years out of the royalties received from the music catalogue.<sup>114</sup> Once the negotiated figure was repaid, the royalties reverted back to Bowie.<sup>115</sup> Because the bond issuance was private, there was no SEC registration and no publicly available prospectus.<sup>116</sup>

Despite the fact that the Bowie transaction was clearly an asset securitization structured as debt, it has prompted comparisons to ISAs because both are instances of someone transferring rights to future earnings in exchange for a current payment. Bowie Bonds involved the transfer of intellectual property rights and associated royalties, rather than, say, a percentage of future wages. However, the similarities and differences between the Bowie transaction and ISAs help pinpoint the contexts in which transfers of future earnings may be worrisome.

#### 4. Yale’s “Tuition Postponement Program”

Finally, ISAs have antecedents in Yale University’s “Tuition Postponement Program,” which included an income-contingent payment feature.<sup>117</sup> Yale students could enter the program from 1971 to 1976, after which it was discontinued (although the repayment plan continued for existing students into the 2000s).<sup>118</sup> Under the terms of this voluntary program, participating students agreed to pay 0.4 percent of their future earnings for every thousand dollars borrowed. Payments would be due for thirty-five years or until the debt of their

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111. Ian Brodie, *Bowie Sells Royalties for 55m to Wall Street*, TIMES (London), Feb. 7, 1997, at 3; *Future Shock? Investors Bet on Rocker’s Royalties*, USA TODAY, Mar. 12, 1997, at 04D, available at 1997 WLNR 3050052; Jay Matthews, *Securities Oddity: The Bowie Bond; with Asset-Backed Debt, the Rock Star Plays Financial Instrument*, WASH. POST, Feb. 6, 1997, at C1, available at 1997 WLNR 7363281; Matt Morris, *Royalty Securitizations: Were Bowie Bonds Just a Fad?*, CAPITAL FORMATION INST., <http://www.cfi-institute.org/VP%20-%20Royalty%20Securitizations%20-%20Morris.html>, archived at <http://perma.cc/XX6V-MSAJ> (last visited Feb. 13, 2015).

112. See Morris, *supra* note 111.

113. *Id.*

114. *Id.* Bowie’s music catalogue was pledged as collateral in the event of SPV default. *Id.*

115. See *Future Shock?*, *supra* note 111.

116. Jennifer Burke Sylva, *Bowie Bonds Sold for Far More Than a Song: The Securitization of Intellectual Property as a Super-Charged Vehicle for High Technology Financing*, 15 SANTA CLARA COMPUTER & HIGH TECH. L.J. 195, 206 (1999).

117. See PALACIOS LLERAS, *supra* note 59, at 43–47, 123–25.

118. *Id.* at 123–24.

class had been paid, whichever occurred first.<sup>119</sup> Ultimately, several factors contributed to dissatisfaction with the program, including its duration and the effect of redistribution within the program depending on the compliance of other participants.<sup>120</sup>

In sum, the present wave of ISAs has antecedents in similar transactions that have occurred in the past and also relates to parallel, present-day developments in human capital investing. We mention some of these transactions and developments in order to situate the new ISAs in historical context but also to pinpoint their distinguishing features. Unlike previous generations of transactions, the new ISAs are more widespread and can be found across the education, entrepreneurship, and professional sports sectors. They are easily accessed via technological platforms and are being offered both by the private sector and by government. Accordingly, the new ISAs impact a broader range of participants than previous generations of transactions. Thus, closer attention to the regulatory issues they raise is warranted.

### C. Relationship to Crowdfunding

Having described the development of ISAs and their antecedents, it is important to discuss how ISAs relate to parallel developments in crowdfunding. “Crowdfunding” is not a technical financing term but is instead a combination of two existing concepts: “crowdsourcing” and “microlending.”<sup>121</sup> Crowdsourcing generally means obtaining services or ideas from a large group of contributors over the Internet,<sup>122</sup> and “microlending” refers to the practice of lending small amounts of money to poor borrowers.<sup>123</sup> The marriage of the two produces crowdfunding: small contributions from many people to fund entrepreneurial projects.<sup>124</sup>

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119. See William E. Curran, *Yale's Tuition Postponement Option*, 2 J.L. & EDUC. 283 (1973).

120. PALACIOS LLERAS, *supra* note 59, at 126–27; Bret Ladine, *'70s Debt Program Finally Ending*, YALE DAILY NEWS, Mar. 27, 2001, <http://yaledailynews.com/blog/2001/03/27/70s-debt-program-finally-ending/>, archived at <http://perma.cc/W27W-VVT2>.

121. The phrase “crowdfunding” did not appear until 2006. C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L REV. 1, 11, 27 (citing Kevin Lawton & Dan Marom, THE CROWDFUNDING REVOLUTION: SOCIAL NETWORKING MEETS VENTURE FINANCING 3 (2010)).

122. Bradford, *supra* note 121, at 27 (quoting Tina Rosenberg, *Crowdsourcing a Better World*, N.Y. TIMES OPINIONATOR BLOG (Mar. 28, 2011, 9:15 PM), [http://opinionator.blogs.nytimes.com/2011/03/28/crowdsourcing-a-better-world/?\\_php=true&\\_type=blogs&\\_r=0](http://opinionator.blogs.nytimes.com/2011/03/28/crowdsourcing-a-better-world/?_php=true&_type=blogs&_r=0)), archived at <http://perma.cc/KSMQ-CYXQ>).

123. MUHAMMED YUNUS & ALAN JOLIS, BANKER TO THE POOR: MICRO-LENDING AND THE BATTLE AGAINST WORLD POVERTY (2008); Bradford, *supra* note 121, at 28–29.

124. Bradford, *supra* note 121, at 29.



Commentators have identified four types of crowdfunding: donative, reward-based, lending-based, and equity-based.<sup>125</sup> Donative crowdfunding (which is not limited to nonprofits) offers contributors nothing in exchange for their contribution.<sup>126</sup> In reward-based crowdfunding, contributors are promised goods or services in exchange for their contribution.<sup>127</sup> In the lending-based model, the crowdfunder is repaid over time; thus, federal securities laws might apply.<sup>128</sup> Finally, equity-based crowdfunding generally refers to the issuance of corporate stock in the startup through a crowdfunding site. Due to securities and regulatory issues, equity crowdfunding has been described as “practically nonexistent in the United States.”<sup>129</sup> Legislation enacted in 2012<sup>130</sup> sought to provide a registration exemption for equity crowdfunding. Whether the proposed SEC regulations<sup>131</sup> implementing that legislation will be sufficient to make equity crowdfunding feasible remains debated.<sup>132</sup>

The key question for our purposes is how, if at all, crowdfunding legislation impacts ISAs. The short answer is that while the crowdfunding exemption may apply to some ISAs, it likely will not apply to all ISAs. Moreover, efforts to provide clarity in securities regulation and protect *investors*, while valuable, do not address the protection of funding seekers—the young persons, entrepreneurs, and students who have monetized their human capital. Finally, the crowdfunding literature simply does not address the most fundamental normative question raised by ISAs: what does it mean that ISA investors are not investing in a company, an activity, or a business but

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125. See *id.* at 31–35; see also Christine Hurt, *Price Disintermediation: Crowdfunding and Online Auction IPOs*, 2015 U. ILL. L. REV. 217, 233–34; Mary M. Shepro, *Keeping the Crowd at Bay: The Practice Implications of the SEC’s New Crowdfunding Exemption*, 1, 9 (May 5, 2014) (unpublished paper), available at <http://ssrn.com/abstract=2433225>.

126. See, e.g., Bradford, *supra* note 121, at 31–32; Shepro, *supra* note 125, at 10 (providing GoFundMe.com as an example of a purely donative crowdfunding site).

127. Kickstarter, a popular crowdfunding site, operates on the reward-based model; entrepreneurs offer rewards (such as copies of the book or film created) in exchange for support. See <https://www.kickstarter.com/hello?ref=footer>, archived at <http://perma.cc/C46N-U5DB> (last visited Jan. 21, 2015).

128. See Bradford, *supra* note 121, at 34–42.

129. See Shepro, *supra* note 125, at 10–11 (citing MASSOLUTION, 2013CF CROWDFUNDING MARKET OUTLOOK REPORT (July 2013)). However, because partnership and LLC interests can constitute securities, even sites that do not offer corporate stock may be subject to costly regulation under current rules.

130. Jump Start Our Business Startups Act (JOBS Act), Title III, Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified in scattered sections of 15 U.S.C. (2012)).

131. Regulation Crowdfunding, 78 Fed. Reg. 66427 (proposed Oct. 23, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, and 249).

132. See, e.g., Shepro, *supra* note 125, at 18–24.

rather the totality of a person's human capital? Such questions are the focus of this Article.

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In sum, Part II has surveyed the universe of current ISAs and discussed their antecedents and related transactions. The foregoing discussion shows that ISAs are not completely new. However, in the past, informal income sharing transactions occurred more sporadically and locally and for the most part flew under the regulatory radar. We have now arguably reached a tipping point where technological advances and a financing crunch have led to the proliferation of ISAs on a wider scale.

The law is just starting to tackle the normative and regulatory issues these transactions raise. Current law lacks both an analytical framework and a substantive approach for understanding, evaluating, and characterizing them. Developments in the regulation of crowdfunding, while informative, do not address many of the key issues. There is clearly a demand for regulatory guidance, as demonstrated by the discontinuation of the Upstart transaction due to regulatory uncertainty<sup>133</sup> and the introduction of the Rubio-Petri Bill.<sup>134</sup> The remainder of this Article elaborates on why, despite the desire for regulatory certainty, a case-by-case approach that regulates ISAs by analogy is the better path.

### III. EVALUATING AND CHARACTERIZING THE TRANSACTIONS

ISAs raise two distinct but related issues: (1) how they should be regarded as a normative, public policy matter, and (2) how we should design their legal treatment and regulation. At the outset, both issues present a fundamental choice: Can we make broad normative statements about the desirability of ISAs and enact overarching legal and regulatory schemes by which to govern them? Or, alternatively,

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133. With regard to Pave, the public portion of the Pave website, which has always been less open, transparent, and detailed than that of Upstart, appears now only to offer a loan version. However, there are Pave webpages still accessible online that continue the description of an income share opportunity. See, e.g., *Payback Process*, PAVE, <https://www.pave.com/learn-more#payback-process>, archived at <http://perma.cc/Z8X7-4Y4V> (last visited Feb. 7, 2015).

134. Investing in Student Success Act of 2014, H.R. 4436, 113th Cong. (as introduced on Apr. 9, 2014); see also *supra* note 27; PALACIOS, DESORRENTO & KELLY, *supra* note 14.

should their normative evaluation and legal treatment be considered and articulated on a case-by-case basis?<sup>135</sup>

Fueled by a desire for regulatory certainty, there has emerged a nascent trend in favor of an overarching, unified regulatory approach.<sup>136</sup> This approach has largely been advocated by legislators and policymakers who seek to provide regulatory certainty and a favorable regulatory environment for the ISA sector to develop. A unified approach may appear a natural solution given the seemingly distinctive economics of ISAs, as compared with more traditional methods of individual financing. This Article argues, however, that we should resist such a unified approach at this stage because, in its effort to secure certainty, the unified approach ignores potential risks posed by ISAs and creates unnecessary substantive law discontinuities. With respect to both normative evaluation and regulatory design, a case-by-case approach offers a better opportunity for thoughtful regulation with meaningful certainty. A case-by-case analysis that is performed by each regulatory field is preferable because (1) ISAs are heterogeneous transactions with different underlying economics, and (2) ISAs may resemble a number of preexisting transactions, many of which already have established legal and regulatory treatments. Furthermore, it is possible to provide sufficient regulatory certainty while choosing a case-by-case approach.

Part III develops the argument that a case-by-case approach that proceeds by analogy to familiar regulatory categories is preferable at this juncture. Part III.A argues that a case-by-case approach is useful both in the normative evaluation of ISAs and in assessing their regulatory treatment. Parts III.B and III.C broadly describe the universe of key commercial transactions analogous to ISAs. Part III.B focuses on two analytical extremes: (1) the notion that ISAs approximate slavery or servitude, and (2) the idea that ISAs are no different from traditional debt. Part III.C then discusses other potential analogies.

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135. A third possibility is to not regulate ISAs at all. However, not subjecting ISAs to any regulatory oversight is unrealistic in today's environment. Moreover, at least with respect to some areas of law (e.g., tax and bankruptcy), deciding the correct approach is not optional.

136. See, e.g., PALACIOS, DESORRENTO & KELLY, *supra* note 14.

*A. Policy Issues Raised by ISAs and the Case for a  
Case-By-Case Approach*

Part III.A first surveys the policy issues raised by ISAs and argues for case-by-case normative evaluation. It then discusses why case-by-case regulation by analogy is the preferable approach.

1. Policy Issues Raised by ISAs and the Case for Case-by-Case  
Normative Evaluation

Commentators—including journalists, bloggers, lawmakers, public intellectuals, and the offering enterprises themselves—have described ISAs in a number of different ways.<sup>137</sup> These descriptions span the analytical spectrum, from the very pernicious (e.g., indentured servitude) to the quite banal (e.g., contingent debt or insurance). Each of these descriptions of ISAs carries different policy implications. The wide range of descriptions, paired with the strength of commentator reactions, suggests that ISAs are commercially and socially complicated and contested.

Advocates of ISAs, including U.S. Senator Marco Rubio and former U.S. Representative Tom Petri, believe that ISAs offer a more realistic means for financing higher education than traditional loans, which may leave students overindebted.<sup>138</sup> The ISA model removes the student's fixed obligation to repay principal, although at the "price" of surrendering a portion of the upside.<sup>139</sup> Some argue that ISAs incentivize students to make better educational decisions.<sup>140</sup> Others claim that the ISA sector taps into new sources of credit and makes it easier for entrepreneurs to obtain funding for a project or venture. Yet others suggest that these transactions enable funders to invest in communities.<sup>141</sup> Still others characterize certain ISAs as a method of

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137. See *infra* Part III.B and III.C.

138. See, e.g., Drew Sandholm, *For Rubio, Student Loan Bill Is Personal*, CNBC (Apr. 9, 2014, 12:17 PM), <http://www.cnbc.com/id/101568230>, archived at <http://perma.cc/4VYV-NCTX>; INVESTING IN STUDENT SUCCESS ACT OF 2014 FACT SHEET, available at <https://web.archive.org/web/20141219075210/https://petri.house.gov/sites/petri.house.gov/files/document/s/InvestingInStudentSuccess-FACTSHEET.pdf>, archived at <http://perma.cc/XVZ8-LWNU> (last visited Feb. 7, 2015). Professor Miguel Palacios is a proponent of this view.

139. See, e.g., Palacios, *supra* note 59.

140. Bachelder, *supra* note 57; see also Michael Simkovic, *Risk-Based Student Loans*, 70 WASH. & LEE L. REV. 527, 530 (2013) (arguing that risk-based student loans would act as a price signal, improving students' ability to make informed decisions regarding how financial risks differ between courses of study).

141. 13TH AVE FUNDING, *supra* note 7 ("Finance your education without debt—use our locally controlled, equity based technology to send members of your community through college.").

insuring against earnings shocks.<sup>142</sup> These commentaries suggest that ISAs may have a number of advantages over traditional methods of individual financing.

On the other hand, several concerns and critiques have been raised concerning the emerging ISA sector. Detractors argue that ISAs create unacceptable ownership stakes in the young at the outset of their careers, akin to indentured servitude.<sup>143</sup> Some suggest that ISAs allow corporations to own people.<sup>144</sup> Such ownership may, in their view, approximate slavery.<sup>145</sup> Detractors voice particular concern about consumer protection issues surrounding young people or those desperate for funding, who may make poor decisions.<sup>146</sup> Even if these transactions do not rise to the level of slavery or servitude, they may raise important questions regarding personal autonomy, free choice, and self-determination. Commentators have also pointed out the likely inequities in who gets funded (e.g., based on race, gender, or profession), as well as potential design flaws (moral hazard and adverse selection in the pool of funding seekers).<sup>147</sup> This increased risk to funding providers may result in ISAs being more costly for funding recipients than currently envisioned. As a result, some have emphasized the importance of consumer protection of funding recipients.<sup>148</sup>

This Article does not purport to undertake a comprehensive survey of the types of policy issues raised by ISAs. The discussion here

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142. Katie Baker, *Jocks & Bonds: Does the Arian Foster IPO Really Give Fans a Chance to Buy a Piece of an NFL Superstar?*, GRANTLAND (Oct. 30, 2013), <http://grantland.com/features/the-arian-foster-ipo-fantex/>, archived at <http://perma.cc/PL68-MAGE> (“The Fantex model can be looked at as an insurance policy of sorts to pros, particularly in the NFL, where contracts are not guaranteed and the average career length is less than four years.”); Mike Florio, *Company Plans to Sell Stock in Players, Starting with Arian Foster*, NBC SPORTS (Oct. 17, 2013), <http://profootballtalk.nbcsports.com/2013/10/17/company-plans-to-sell-stock-in-players-starting-with-arian-foster/>, archived at <http://perma.cc/ZS74-6H73> (characterizing Fantex as “an insurance policy of sorts, paid in advance”); Sean Gregory, *Be Very Careful Buying Arian Foster Shares*, TIME (Oct. 18, 2013, 7:29 PM), <http://keepingscore.blogs.time.com/2013/10/18/be-very-careful-buying-arian-foster-shares/>, archived at <http://perma.cc/C6P3-TGZY> (noting the insurance function of Fantex). See also, generally, Lee Anne Fennell, *Unbundling Risk*, 60 DUKE L.J. 1285, 1319–24 (2011) (discussing equity interests in future earnings as a non-insurance example of a “risk-allocating transaction” or “risk/expected value exchange”).

143. See *infra* notes 167–70 and accompanying text.

144. *Id.*

145. *Id.*

146. *Id.*

147. See, e.g., Schwartz, *supra* note 4 (manuscript at 39:59) (discussing potential funding inequities based on demographic characteristics); see also PALACIOS, DESORRENTO & KELLY, *supra* note 14, at 10 (discussing possible funding inequities). For example, there is a worry that funding recipients may have an incentive to choose leisure over work, take lower paying jobs, or accept hometown discounts upon receiving the funds, thus compromising the return on the investment of funding providers.

148. See Schwartz, *supra* note 4 (manuscript at 35:59–39:59).

is simply a brief overview of the types of issues ISAs may present. What is clear at the outset is that ISAs are contested and complicated transactions. They are also heterogeneous, so not all ISAs will raise the exact same policy concerns. Ultimately, whether a given agreement is desirable or problematic will depend in part on the economic terms of that particular contract, the circumstances surrounding its creation, and the relationship between the contracting parties. Because ISAs are not monolithic, it is difficult to make sweeping normative statements about ISAs as a whole. For that reason, we suggest that each contract should be normatively evaluated on a case-by-case basis. Comparison, analogy, and classification can be useful in this normative evaluation. Comparing ISAs to more familiar transactions can help clarify potential arguments and concerns, because we can piggyback on implicit or explicit normative assessments of existing categories in deciding how we feel about specific ISAs. Comparison and analogy can also help pinpoint—based on careful examination of the economics underlying each discrete transaction—whether and when a particular transaction raises concerns. For example, understanding how a given ISA is or is not like insurance can help clarify whether it is plausible to argue that ISAs allow smoothing of earnings and consumption shocks. Understanding how an ISA may or may not resemble indentured servitude may illuminate the potential ethical problems that it creates.

In sum, thinking about how ISAs compare with arrangements with which we are familiar can help us better understand and articulate our normative attitudes towards them. Of course, merely drawing analogies is insufficient. Some new ISAs may raise fresh issues that existing transactions do not implicate. The process of analogizing may also force us to rethink the wisdom of our longstanding acceptance of familiar financial transactions. Our narrower point is that the work of analogy and comparison can serve as a heuristic in helping us frame and evaluate the new ISAs in a quickly changing landscape.

## 2. The Case for Case-By-Case Regulation by Analogy

With respect to designing the legal and regulatory treatment of ISAs, a case-by-case approach that draws analogies to preexisting transactions is also likely to be preferable.<sup>149</sup>

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149. See generally Bar-Gill & Warren, *supra* note 15 (borrowing products liability concepts to suggest consumer credit regulation approaches).

*a. Benefits of Regulation by Analogy*

Regulation of ISAs by analogy to more familiar arrangements is advisable for two reasons:

First, as mentioned, ISAs are heterogeneous. Some are structured using intermediate entities, while others are peer-to-peer.<sup>150</sup> Some are pooled funds while others are not.<sup>151</sup> Some may attempt to circumscribe the activities of the funding recipients while others may not.<sup>152</sup> Furthermore, new variants are likely to develop. Given this heterogeneity, enacting new regulatory schemes to govern ISAs at this stage may be either over- or underinclusive and may miss some of the issues that will arise, simply because we have not yet had enough experience or time to determine the pitfalls, potential abuses, alternative structures, and potential workarounds.

Second, many ISAs economically resemble existing arrangements that are already governed by established legal and regulatory regimes. Analogizing each new ISA to familiar transactions may suggest the types of rules and protections that should apply. There is no reason not to benefit from regulatory insights and approaches already developed for economically similar transactions.

Given the heterogeneity of ISAs and their resemblance to more familiar arrangements, efficiency and equity considerations suggest that if an ISA is economically comparable to another transaction, both should receive similar treatment under the law. From an equity perspective, if two transactions are economically identical, they should be treated identically as an analytical starting point, and the

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150. For example, Pave was designed to be a peer-to-peer financing arrangement. *See supra* Part II.A.3. In contrast, Upstart interposed itself, or a related trust entity, between the investors and the funding seeker. *See supra* Part II.A.2; *see also* Oei & Ring, *supra* note 3, at 269 n.16.

151. *See supra* Part II.A.4.a (Lumni as an example of a structure using pooling); *see also* Charles Luzar, *Pave Has Crowdfunded Individuals . . . Now They Will Fund Groups*, CROWDFUND INSIDER (Feb. 4, 2014, at 9:00 AM), <http://www.crowdfundinsider.com/2014/02/31292-pave-crowdfunded-individuals-now-want-fund-groups/> (Pave introducing the opportunity for Backers to invest in a *group* of individuals to facilitate investor diversification).

152. For example, under the Fantex structure, the funding recipient is expected to remain engaged in the specified sports-related activities for a minimum period of time (except in the case of injury or other enumerated events). Fantex, Inc., Registration Statement Under the Securities Act of 1933 (Form S-1) 6 (Nov. 21, 2013), *available at* <http://www.sec.gov/Archives/edgar/data/1573683/000104746913010747/a2217440zs-1.htm>, *archived at* <http://perma.cc/BXP6-R6EW>. Both Upstart and Pave emphasize how their funding structure constitutes an investment in the *person* and not the *activity*. *See, e.g.*, Oei & Ring, *supra* note 3, at 267; PAVE, <http://web.archive.org/web/20140106223438/http://www.pave.com/>, *archived at* <http://perma.cc/WK2Y-9DAK> (last visited Feb. 7, 2015) (describing the Pave agreement as an investment “in an individual, not a project or company”). Under the Upstart contract, the funding recipient makes payments based on a percentage of the income listed on Line 22 of the tax return, which is not limited to any particular activity or line of business. Oei & Ring, *supra* note 3, at 270.

government should be prepared to explain any disparate treatment.<sup>153</sup> From an efficiency perspective, treating two economically similar transactions differently may create distortions and incentivize people to enter into one over the other solely for regulatory reasons.<sup>154</sup>

We do not argue that deviations from identical treatment should never occur. In certain cases, it may be advisable to regulate a unique industry or activity under special rules. However, this should be done only after careful consideration and for sound policy reasons.<sup>155</sup> Because ISAs are so new, the initial default should be comparable treatment until good reasons can be articulated for doing something different. The worry is that designing a new unified regulatory regime at the outset might have the unintended effect of drawing numerous new lines between like-kind transactions without a thorough understanding of where the lines are and where the resulting distortions are likely to be.<sup>156</sup> It is also possible that any new regulatory regime enacted at this time may be less protective of funding recipients than existing regulatory regimes might be. The better approach is regulation by analogy on a case-by-case basis until the sector is more developed.

*b. Possible Objections to the Case-by-Case Approach*

There are potential counterarguments to our suggested approach. First, it might be argued that regulation by analogy itself creates arbitrage by allowing parties to pick their desired regulatory regime based on similarities to existing transactions.<sup>157</sup> It may also create arbitrage opportunities between fields, whereby transactions could be structured to receive one label for purposes of field A and another for purposes of field B. Yet, this is no different than the world we currently inhabit. For example, parties willing to undertake the economics of debt already receive debt treatment. Similarly, parties have long been able to exploit arbitrage opportunities between fields.

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153. See James Repetti & Diane Ring, *Horizontal Equity Revisited*, 13 FLA. TAX REV. 135, 139 (2012) (arguing that equity—horizontal and vertical—has no independent normative content, but the concept plays a role in demanding that a government communicate its rationale for different treatment).

154. See, e.g., Weisbach, *supra* note 16, at 1631 (observing that where a line is drawn, “taxpayers will change their behavior to take advantage of the line. . . [creating] efficiency effects.”).

155. *Id.* at 1661–62 (urging a general approach of taxing close substitutes comparably).

156. See generally Strnad, *supra* note 16, at 571–72, 574 (critiquing an approach to taxing new financial instruments that would apply a single regulatory regime to all new instruments, on the grounds that “instruments with nearly identical cash flows may incur very different tax liabilities.”).

157. See generally Victor Fleischer, *Regulatory Arbitrage*, 89 TEX. L. REV. 227 (2010) (describing the “first comprehensive theory of regulatory arbitrage”).



Any reforms of this systemic reality should take place as part of a broader conversation.<sup>158</sup>

Second, it might be argued that the case-by-case approach creates regulatory uncertainty that could stifle a burgeoning industry. We offer two responses to this critique. We agree that the decision by Upstart to suspend new ISA issuances and Pave's decision to emphasize loans may be due in part to regulatory uncertainty. But we contend the answer is not quick enactment of broad and inconsistent ISA legislation. Reform efforts should not conflate regulatory certainty with creation of a unified legal regime for ISAs. It is possible to generate greater certainty while eschewing substantive uniformity by pursuing regulation by analogy. This could be done, for example, by employing carefully tailored prototype guidance issued by the relevant regulatory authorities, which could act as narrowly crafted safe harbors. This is an approach already utilized by regulators in various contexts.<sup>159</sup> Additionally, despite its tempting allure of certainty, substantive uniformity in the treatment of ISAs does not necessarily guarantee regulatory certainty in application. A unified approach would likely cause problems due to the creation of unnecessary legal distinctions and distortions. Furthermore, some uncertainty is not inherently bad. As noted, ISAs, while promising, also contain pitfalls. A degree of regulatory uncertainty may act as a friction against aggressive versions of these transactions at the margins.<sup>160</sup>

Third, it is possible that in certain cases, regulation by analogy may lead to the wrong result. Two transactions may be economically similar, yet regulation by analogy may produce an illogical outcome. For example, a transaction that is not the closest analogy for the ISA could, in practice, serve as its closest substitute in the marketplace. In such circumstances, it might be sensible to consider regulatory treatment consistent with the closest substitute, rather than the closest analogy. We do not contend that regulation by analogy will always reach the right result. In cases where it does not, it may be appropriate to consider deviating from the rule of choosing the most analogous transaction. But

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158. For example, see the conversation regarding reforming the tax treatment of the cost of capital and the distinction between debt and equity. *See, e.g.*, Daniel Halperin, *Fundamental Tax Reform*, 48 EMORY L. J. 809 (1999); David Hasen, *A Realization-Based Approach to the Taxation of Financial Instruments*, 57 TAX L. REV. 397 (2004); Katherine Pratt, *The Debt-Equity Distinction in a Second-Best World*, 53 VAND. L. REV. 1055 (2000); Daniel Shaviro, *Risk Based Rules and the Taxation of Capital Income*, 50 TAX L. REV. 643 (1995); Graeme S. Cooper, *Coordinating Inconsistent Choices—The Problem of Hybrids* (Dec. 14, 2014) (unpublished paper), available at <http://ssrn.com/abstract=2538276>.

159. *See* RILEY, *supra* note 18.

160. *See, e.g.*, David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312, 1331 (2001) (tax uncertainty may prevent a structure “from becoming pervasive”).

such deviation should be undertaken for clearly articulated reasons, in circumscribed contexts. In general, regulating based on careful analogies to existing rules and regimes remains the better course.

Finally, unified regulation might provide benefits that are absent in our approach. For example, creation of a clear and unified regulatory scheme may allow regulators to direct the development of the young industry and to put a stamp of approval on “good” transactions by protecting them. It may give rise to certainty, which can facilitate development of the “good” parts of the industry. However, these benefits should not be overstated.

Lawmakers and regulators have a long history of not anticipating the variants that an industry can create. There are real risks of being overinclusive in defining a “good transaction.” These tendencies might be exacerbated by the presence of interest groups and the possibility of regulatory capture.<sup>161</sup> Many of those calling for a unified regulatory regime strongly support ISAs and may not appreciate (or may be understating) the downsides they present. Given these realities, any unified scheme that is enacted would most likely be overly broad.<sup>162</sup>

Furthermore, regulatory certainty itself will not necessarily ensure that desired transactions flourish. Recently proposed SEC regulations sought to facilitate certain types of crowdfunding. However, some commentators speculate that the new rules will be inadequate to persuade market actors to pursue new offerings.<sup>163</sup> Successful regulation requires understanding the actors, their concerns, and the consequences of regulations, all of which depends on experience.

### *c. Concluding Thoughts on Regulation by Analogy*

For the foregoing reasons, we believe that a case-by-case approach that draws analogies to more familiar transactions is

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161. See, e.g., Steven P. Croley, *Theories of Regulation: Incorporating the Administrative Process*, 98 COLUM. L. REV. 1, 5 (1998) (noting a view that where “relevant decisionmakers operate without any oversight, they tend to deliver benefits to well organized interest groups at the public’s expense”); see also Jonathan S. Masur & Eric Posner, *Toward a Pigovian State*, 164 U. PENN. L. REV. (forthcoming 2015) (critiquing governments’ propensity to use command and control regulations rather than more efficient Pigovian taxes and noting the role of interest groups in the design of regulation); Oren Bar-Gill & Cass R. Sunstein, *Regulation as Delegation* (Feb. 25, 2015) (unpublished paper), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2570669](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2570669) (considering how different regulatory techniques map onto different levels of delegation of decision making to the state).

162. We are open to the possibility of a narrowly crafted safe harbor—for example, one that protects peer-to-peer transactions of short duration and small income sharing percentage. Any such safe harbor should be carefully designed to avoid the dangers we have discussed here.

163. See Shepro *supra* note 132.

preferable to pursuing a unified framework for the new transactions at this time.

We do not argue that regulators and lawmakers should stand back and ignore ISAs, letting them grow unfettered.<sup>164</sup> Rather, we recommend building on the rules and protections already developed with respect to other arrangements, and borrowing from those concepts in regulating the new transactions. This is a particularly reasonable approach given the recent advances in consumer protections for consumer financial products.<sup>165</sup> We are concerned that the creation of new legal rules and regulations at this juncture is less likely to be well-tailored and adequately protective of consumers and investors.<sup>166</sup> While there may be some benefits of a unified regime that are forgone by choosing a case-by-case approach, these benefits are outweighed by the merits.

### *B. The Analytical Extremes: Human Ownership? Or Debt?*

Having argued for case-by-case regulation by analogy, the remainder of Part III discusses the universe of arrangements to which ISAs might be analogized. Part III.B examines two analytical extremes: (1) the parallel between ISAs and slavery or servitude and (2) the idea that ISAs are simply a form of contingent debt. Part III.C examines other possible analogies.

#### 1. Income Share Agreements as Slavery or Indentured Servitude

Even though ISAs obviously do not create direct property rights in humans, the worry is that they might approximate such property rights via financial contract. Upstart has been characterized in the popular press as possibly being “a modern form of indentured

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164. Cf. Jack Goldsmith, *Against Cyberanarchy*, 65 U. CHI. L. REV. 1199, 1201 (1998) (showing why the claim that cyberspace cannot be effectively regulated by the government is flawed); Saule T. Omarova, *The Quiet Metamorphosis: How Derivatives Changed the “Business of Banking,”* 63 U. MIAMI L. REV. 1042 (2009) (arguing that Office of the Comptroller of the Currency decisions to expand U.S. commercial banks’ ability to engage in derivatives trading in a largely unregulated environment contributed to the financial crisis in 2008).

165. See, for example, the creation of the Consumer Financial Protection Bureau (“CFPB”) in the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1011 124 Stat. 1376, 1964 (2010) (codified at 12 U.S.C. § 5491 (2012)).

166. See, e.g., Brett McDonnell & Daniel Schwarcz, *Regulatory Contrarians*, 89 N.C. L. REV. 1629, 1637 (2011) (contending that “regulatory capture [is] a more pronounced problem for consumer protection” regulation); see also Charles K. Whitehead, *The Goldilocks Approach: Financial Risk and Staged Regulation*, 97 CORNELL L. REV. 1267 (2012) (arguing that introducing financial regulation in stages may be a better approach for managing risk and avoiding unintended consequences).

servitude.”<sup>167</sup> The Fantex transaction has been described as owning a NFL athlete and as “creepy.”<sup>168</sup> Similar accounts can be found in a variety of commentaries.<sup>169</sup> The offering startups themselves have also, to varying degrees, characterized these instruments as resembling human ownership.<sup>170</sup>

These descriptions, if accurate, raise clear public policy and regulatory concerns.<sup>171</sup> If an arrangement too closely resembles servitude or slavery, we already have legal and ethical frameworks for thinking about it. For example, we might consider whether the transaction should be subject to constitutional scrutiny,<sup>172</sup> whether it

167. Elliot Hannon, *Is This Indentured Servitude or the New Venture Capital?*, SLATE (Oct. 29, 2013, 10:45 AM), [http://www.slate.com/blogs/moneybox/2013/10/29/companies\\_look\\_to\\_loan\\_you\\_money\\_in\\_return\\_for\\_a\\_percentage\\_of\\_your\\_future.html](http://www.slate.com/blogs/moneybox/2013/10/29/companies_look_to_loan_you_money_in_return_for_a_percentage_of_your_future.html), archived at <http://perma.cc/HTM7-MRDY>.

168. Matt Levine, *Football Player Derivatives Are the Best Derivatives*, BLOOMBERGVIEW (Nov. 1, 2013, 4:13 PM) <http://www.bloombergview.com/articles/2013-11-01/football-player-derivatives-are-the-best-derivatives>, archived at <http://perma.cc/H3AR-FB23> (“The squick factor is obvious—you’re buying a person! indentured servitude! etc. . . .”); Jonathan Mahler, *Want to Buy Stock in an NFL Running Back?*, BLOOMBERGVIEW (Oct. 29, 2013, 2:47 PM), <http://www.bloombergview.com/articles/2013-10-29/want-to-buy-stock-in-an-nfl-running-back->, archived at <http://perma.cc/5J7B-LRDP> (“The first initial public offering for an athlete is under way!”).

169. See, e.g., Ken Previti, *The American School for Indentured Servants*, RECLAIM REFORM (June 19, 2013), <http://reclaimreform.com/2013/06/19/the-american-school-for-indentured-servants/>, archived at <http://perma.cc/T6R4-NQPY> (“College age students are being legally indentured”); Kevin Robertson, *Owning a Player: Fantex and the Arian Foster IPO*, THE SPORTS LAW CANARY (Nov. 23, 2013), <http://sportslawnews.wordpress.com/2013/11/23/owning-a-player-fantex-and-the-arian-foster-ipo/>, archived at <http://perma.cc/SVJ3-HC5J> (“There is something morally wrong for a society that has moved past slavery to then allow a person to become indebted to another for life.”); David von Ebers, *Athletes for Sale*, THIS WEEK IN BLACKNESS (Oct. 17, 2013), <http://thisweekinblackness.com/david-von-ebers/athletes-for-sale/>, archived at <http://perma.cc/ST2P-UFZY> (noting that “[t]he very idea of ‘owning’ a piece of an athlete is unsettling” and that “the concept evokes images of slavery, albeit highly paid slavery”); see also Oei & Ring, *supra* note 3, at 267 nn.3–7 (providing further examples). But see Mark O’Neill, *Upstart: Backers Invest in You, and Your Future Earnings Repay Them*, SMALL BUS. TRENDS (Feb. 20, 2014), <http://smallbiztrends.com/2014/02/upstart-backers-invest-future-student-earnings.html>, archived at <http://perma.cc/8DP5-8WYG> (calling criticism of Upstart “harsh” because the program gives a person the “start he or she needs” and “[limits] backers in the amount they get in return”); James Surowiecki, *The New Futurism*, THE NEW YORKER, Nov. 4, 2013, <http://www.newyorker.com/magazine/2013/11/04/the-new-futurism>, archived at <http://perma.cc/D9EM-QW8E> (noting that although some people describe this funding as “indentured servitude. . . the analogy is flawed”).

170. See *Fund Your Future*, UPSTART, <http://web.archive.org/web/20140419222848/zzhttps://www.upstart.com/>, archived at <http://perma.cc/K7HR-5RE4> (last visited Feb. 7, 2015) (“By borrowing from their future selves, upstarts can make the best decisions for their lives today.”). Another Upstart ad characterized ISAs as transactions in which “people invest in people.” Upstart Ad on BOSTON.COM (Apr. 22, 2014) (on file with the authors); see also *How It Works*, PAVE, <https://web.archive.org/web/20140327134603/http://www.pave.com/how-it-works>, archived at <http://perma.cc/HF6L-82YB> (last visited Feb. 7, 2015) (“Talent is an asset”).

171. See Oei & Ring, *supra* note 3, at 272–73 (discussing some of these concerns).

172. See U.S. CONST. amend. XIII.

might violate the Peonage Abolition Act of 1867,<sup>173</sup> whether it might violate treaty obligations,<sup>174</sup> or whether it should otherwise be banned on public policy grounds.<sup>175</sup>

The involuntary servitude/slavery characterization may seem inapt because there are clear differences between ISAs and slavery or indentured servitude as commonly understood.<sup>176</sup> ISAs do not actually make a person someone else's property. They do not force funding recipients to work for funding providers.<sup>177</sup> Work done is compensated, and there are often no formal restrictions on choice of work.<sup>178</sup>

On the other hand, the analogy is not entirely unfounded.<sup>179</sup> First, the comparison should not be taken literally. Commentators are obviously not suggesting that ISAs are identical to slave or indentured servant relationships, as those terms have been understood in our cultural context. Rather, the significant point is that ISAs trigger reflexive comparisons to slavery or servitude for some observers. The real question is, what is it about these transactions and the rights they convey that generates this response?

For example, the possibility of an investor capturing an overly large return, or taking too large a percentage, may elicit a reaction that

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173. 42 U.S.C. § 1994 (2012).

174. Supplementary Convention on the Abolition of Slavery, the Slave Trade, and Institutions and Practices Similar to Slavery § I, art. 1, April 30, 1957, 266 U.N.T.S. 3, *available at* [treaties.un.org/doc/Publication/UNTS/Volume%20266/v266.pdf](http://treaties.un.org/doc/Publication/UNTS/Volume%20266/v266.pdf), *archived at* <http://perma.cc/LF8J-FQ8N>.

175. Such public policy restrictions would not be unprecedented. *See, e.g.*, National Organ Transplant Act of 1984, Pub. L. No. 98–507, § 301, 98 Stat. 2339, 2346 (1984) (codified at 42 U.S.C. § 274e) (making it illegal to “transfer any human organ for valuable consideration”); *see also* Kimberly D. Krawiec, *A Woman's Worth*, 88 N.C. L. REV. 1739 (2010) (discussing legal regulation and constraints on markets for various “taboo transactions”).

176. *See* Kyle Chayka, *Investing in Human Capital, Literally*, PAC. STANDARD, Mar. 26, 2014, <http://www.psmag.com/navigation/business-economics/investing-human-capital-literally-77448/>, *archived at* <http://perma.cc/9PTP-8RYC> (“Crowd-investing . . . actually seems more like a guild or apprenticeship system.”); O’Neill, *supra* note 169 (if these transactions “give[] the person the start he or she needs, and backers are limited in the amount they get in return, calling it indentured servitude seems like harsh criticism”).

177. *Cf.* *Bailey v. Alabama*, 219 U.S. 219, 227–29 (1911). In that case, Bailey obtained \$15 from a corporation in exchange for agreeing to work for a year at \$12 a month, \$1.25 of which would go to the corporation. An Alabama law treating failure to perform without just cause as *prima facie* evidence of intent to defraud violated the Thirteenth Amendment.

178. *But see* *Fantex, Inc.*, *supra* note 1, at 25 (stating that if Davis “retires from the NFL . . . within two years following [the stock] offering, other than as a result of injury, illness or medical condition, [Fantex] . . . may elect in our sole discretion to terminate the brand contract” and Davis must repay the funded amount net of amounts already repaid).

179. *See* WILLIAM C. RHODEN, *FORTY MILLION DOLLAR SLAVES: THE RISE, FALL, AND REDEMPTION OF THE BLACK ATHLETE* (2007).

there is excessive control over another human.<sup>180</sup> The fact that some ISAs involve market-based, commodifying valuations of the recipient's human capital may accentuate their property and ownership-like aspects.<sup>181</sup> If the investor's interest in the future income stream is tradable, this may also emphasize the ownership-like aspects, as may the race-based dimensions of some ISAs.<sup>182</sup> The presence of minimum payment amounts, minimum work periods, or default clauses may also suggest servitude.<sup>183</sup>

Second and relatedly, slavery and servitude are themselves distinct and multifaceted institutions.<sup>184</sup> While slavery in the United States generally involved a property interest in the enslaved person, indentured servitude was a kind of debt bondage. In exchange for a benefit (e.g., free passage), the indentured servant was required to work for a number of years to pay off his indenture.<sup>185</sup> Both institutions have also varied depending on geographical and historical context. For example, historians have identified differences in U.S. slavery depending on time period (eighteenth vs. nineteenth century), geography (north vs. south), and gender and age of those enslaved.<sup>186</sup> A full discussion of slavery and indentured servitude—particularly as

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180. Such concerns may also underlie characterization of industrial worker working conditions as “wage slavery.” See, e.g., AMY DRU STANLEY, FROM BONDAGE TO CONTRACT: WAGE LABOR, MARRIAGE, AND THE MARKET IN THE AGE OF SLAVE EMANCIPATION 60–97 (1998); Lea S. Vandervelde, *The Labor Vision of the Thirteenth Amendment*, 138 U. PA. L. REV. 437, 474 (1989) (discussing the “wage slavery” debate in the labor movement).

181. The question of what types of market transfers should be allowed is the subject of a robust literature on commodification. See generally MARTHA ERTMAN & JOAN C. WILLIAMS, RETHINKING COMMERCIALIZATION: CASES AND READINGS IN LAW & CULTURE (2005); MARGARET JANE RADIN, CONTESTED COMMODITIES (2001); Krawiec, *supra* note 175 (discussing “taboo transactions”); Margaret Jane Radin, *Market-Inalienability*, 100 HARV. L. REV. 1849, 1849–52 (1987) (developing a “human flourishing” theory of “market inalienability”).

182. See sources cited *supra* note 181; see also DOROTHY ROBERTS, KILLING THE BLACK BODY: RACE, REPRODUCTION, AND THE MEANING OF LIBERTY (1997); Anthony Paul Farley, *The Black Body as Fetish Object*, 76 OR. L. REV. 457, 458–61 (1997).

183. See Fantex, Inc., *supra* note 1, at 25.

184. See sources cited *infra* notes 185–86 and accompanying text; see also GUNTHER PECK, REINVENTING FREE LABOR: PADRONES AND IMMIGRANT WORKERS IN THE NORTH AMERICAN WEST, 1880–1930, at 82–112 (2000).

185. Alfred L. Brophy, *Law and Indentured Servitude in Mid-Eighteenth Century Pennsylvania*, 28 WILLAMETTE L. REV. 69, 85 (1991); Sharon V. Salinger, *Labor, Markets, and Opportunity: Indentured Servitude in Early America*, 38 LAB. HIST. 311, 314 (1997); see also sources cited *infra* note 186.

186. See STACEY K. CLOSE, ELDERLY SLAVES OF THE PLANTATION SOUTH (1997); ELIZABETH FOX-GENOVESE, WITHIN THE PLANTATION HOUSEHOLD 146–192 (1988) (discussing lives of elderly slaves); DEBORAH GRAY WHITE, AR’N’T I A WOMAN? FEMALE SLAVES IN THE PLANTATION SOUTH (1999); WILMA KING, STOLEN CHILDHOOD: SLAVE YOUTH IN NINETEENTH-CENTURY AMERICA (2d ed. 2011); JOHN BLASSINGAME, THE SLAVE COMMUNITY: PLANTATION LIFE IN THE ANTEBELLUM SOUTH 149–190, 223–322 (1979) (discussing stereotypes, institutional roles, and the family in slavery).

understood by popular commentators—is beyond the scope of this Article. The key point is that the analogy between ISAs and slavery or servitude should not be cursorily dismissed. ISAs do create some degree of impingement on one’s right to reap the fruits of one’s own human capital. The relevant question is whether a given ISA so impinges on this right as to replicate or approximate some servitude or slavery-like characteristics in a modern-day financial transaction.

Third, while ISAs would probably not run afoul of the Thirteenth Amendment under current court interpretations, the analysis cannot stop there. Although the Thirteenth Amendment has been narrowly construed and is unlikely to implicate financing transactions,<sup>187</sup> various scholars have advocated a broader jurisprudence.<sup>188</sup> Furthermore, even if a transaction is not unconstitutional, lawmakers may decide to restrict or prohibit it on public policy grounds. This has been done with transactions considered unacceptably commodifying or exploitative, such as sales of certain body parts.<sup>189</sup> ISAs share some of these commodification concerns.

The deeper question, then, is whether ISAs contractually approximate servitude, slavery, or some other type of commodifying or exploitative relationship as a result of the underlying rights and relationships they create. Because different agreements parcel out

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187. See *United States v. Kozminski*, 487 U.S. 931, 931 (1988) (“[T]he term ‘involuntary servitude’ necessarily means a condition of servitude in which the victim is forced to work for the defendant by the use or threat of physical restraint or physical injury, or by the use or threat of coercion through law or the legal process.”). *But see* *Pollock v. Williams*, 322 U.S. 4 (1944) (explaining a Florida statute creating a presumption of fraud from nonperformance of contract for labor violated the Thirteenth Amendment and Anti-Peonage Act).

188. Samuel L. Bufford & Erwin Chemerinsky, *Constitutional Problems in the 2005 Bankruptcy Amendments*, 82 AM. BANKR. L.J. 1, 27–36 (2008) (examining possibility that involuntary Chapter 11 plans may violate the Thirteenth Amendment); Karen Gross, *The Debtor as Modern Day Peon: A Problem of Unconstitutional Conditions*, 65 NOTRE DAME L. REV. 165, 169 (1990) (suggesting that a debtor “has sufficient aspects in common with a peon” to implicated the Thirteenth Amendment); James Gray Pope, *Contract, Race, and Freedom of Labor in the Constitutional Law of “Involuntary Servitude,”* 119 YALE L.J. 1474, 1502–15 (2010) (articulating a standard for evaluating labor claims under the Involuntary Servitude Clause of the Thirteenth Amendment).

189. See sources cited *supra* notes 175 and 181 and accompanying text; see also, e.g., G.S. Becker & J.J. Elias, *Introducing Incentives in the Market for Live and Cadaveric Organ Donations*, 21 J. ECON. PERSP. 3, 9 (2007) (noting that the current legislation prohibits payments for organs); S. Leider & A.E. Roth, *Kidneys for Sale: Who Disapproves, and Why?*, 10 AM. J. TRANSPLANTATION 1221, 1221 (2010) (discussing the National Organ Transplant Act and “repugnance” toward selling kidneys); Erik Malmqvist, *Are Bans on Kidney Sales Unjustifiably Paternalistic?*, 28 BIOETHICS 110, 114–17 (2014) (listing arguments for and against legislation concerning the sale of kidneys); A.J. Matas, *The Case for Living Kidney Sales: Rationale, Objections and Concerns*, 4 AM. J. TRANSPLANT 2007, 2009–13 (2004) (discussing a myriad of concerns including “exploitation of the poor” and “commodification of the body”); Julian Savulescu, *Is the Sale of Body Parts Wrong?* 29 J. MED. ETHICS 138, 138–39 (2003) (noting that selling organs may force the poor into the market).

different rights, one cannot conclude whether a given ISA approximates servitude or slavery without a case-by-case analysis. We propose a multifactor framework for doing such analysis in Part IV.

## 2. Income Share Agreements as Debt

At the other end of the analytical spectrum, ISAs might be regarded as simply a form of contingent debt. Both debt and ISAs involve a transfer of funds up front in return for payments under a contract. Upstart itself initially characterized its arrangement as essentially a loan in its transaction documents.<sup>190</sup> Debt characterization typically leads to the normative conclusion that, despite their distinctive marketing, ISAs are not special. The corresponding regulatory conclusion is that, because debt is a familiar form of individual financing that falls under well-developed regulatory regimes, few or no new regulatory structures are needed to govern ISAs.

There are clear similarities between ISAs and debt, and some ISAs may look so much like debt that they are economically indistinguishable. The fact that ISAs are income contingent might not prevent a debt designation. Individuals have long entered into lending transactions in which interest rates vary based on market interest rates or other benchmarks.<sup>191</sup> Depending on other investor protections, an ISA with repayment contingent on future earnings could be viewed as just another type of variable rate debt.<sup>192</sup>

Debt characterization may be buttressed in cases where the funding provider receives robust protections from downside risk, for example, through deferral clauses that extend the repayment term in years where the funding recipient's income is too low. The return on investment may also appear more fixed and debt-like in the case of agreements that cap the upside return, although high upsides can be found in some payday-lending arrangements as well and do not preclude debt characterization.<sup>193</sup> As discussed in Part II, some

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190. See Oei & Ring, *supra* note 3, at 273–74 (describing Upstart's shifting characterization).

191. For example, interest rates linked to LIBOR (London Inter-bank Offered Rate), or Bond Buyer's 20 bond index (used to establish cost of municipal, tax-free debt). See *Bond Buyer's 20 Bond Index*, BANKRATE.COM, <http://www.bankrate.com/rates/interest-rates/bond-buyer-20-bond-index.aspx>, archived at <http://perma.cc/KDF3-249M> (last visited Feb. 14, 2015); LIBOR, Other Interest Rate Indexes, BANKRATE.COM, <http://www.bankrate.com/rates/interest-rates/libor.aspx>, archived at, <http://perma.cc/N3QW-8USK> (last visited Feb. 14, 2015).

192. Surowiecki, *supra* note 169 (“[A]t root, a human-capital contract is what's called an income-contingent loan: how much you pay back depends on how much you earn.”). *But see* I.R.C. § 351(g) (2012) (borderline instruments receive equity treatment).

193. See, e.g., Alex Kaufman, *Payday Lending Regulation* 1–7 (Finance and Econ. Discussion Series, Div. of Research & Statistics and Monetary Affairs, Fed. Reserve Bd., Working Paper No. 2013-62, 2013), available at <http://www.federalreserve.gov/pubs/feds/2013/201362/201362pap.pdf>,



transactions do place floors and ceilings on the repayment obligations of the funding recipients, and future variants could certainly move further in this direction.<sup>194</sup>

However, the debt analogy may not sufficiently capture the full complexity of the new ISAs. There is arguably a distinction between debt instruments that vary based on a market interest rate or other benchmark and an instrument that varies based on a person's future earnings.<sup>195</sup> The latter may look more like an ownership interest in human capital than the former, and debt characterization may not capture this nuance. Furthermore, in most ISAs there is no formal obligation to repay the principal amount, even if there are informal pressures, which means additional risk for the funding provider.<sup>196</sup>

Thus, like the servitude or slavery analogy, whether an ISA can be classified or analogized as debt will depend on the economics of the individual transaction. Of course, just because a transaction looks like debt does not mean it is unproblematic. If anything, comparing and analogizing to more traditional forms of lending illuminates the risks and potential problems with *both* ISAs *and* traditional debt. Our point is simply that if an ISA is closely analogous to debt, we should consider borrowing from existing normative and regulatory approaches that apply to traditional debt in designing that ISA's legal treatment.

### C. The Equity-Like Gray Zone

Apart from slavery/servitude and debt characterization, ISAs may also be analogized to other arrangements that are not debt but do not rise to the level of human ownership. Broadly speaking, there are three basic categories of such "gray-zone" analogies: (1) corporate equity, (2) partnership or joint venture, and (3) a residual category of other arrangements that look like equity but may be something else.

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archived at <http://perma.cc/LX32-LKQE> (reviewing policy issues surrounding payday lending); Rachel Swan, *San Francisco Start-Up Drafts 49er Vernon Davis for IPO Roster* S.F. WEEKLY: THE SNITCH BLOG (Oct. 31, 2013, 1:38 PM), [http://blogs.sfweekly.com/thesnitch/2013/10/vernon\\_davis\\_fantex.php](http://blogs.sfweekly.com/thesnitch/2013/10/vernon_davis_fantex.php), archived at <http://perma.cc/JC3Y-JCJU> (noting that athletes may not necessarily come out ahead in these deals).

194. For example, Upstart's transaction capped repayments at three times the amount funded. See UPSTART FUNDING AGREEMENT, *supra* note 28 and accompanying text. Pave's has an effective cap of five times the amount funded. See *supra* note 47 and accompanying text.

195. *But see* I.R.C. § 351(g) (nonqualified preferred stock not treated as stock).

196. Note that some agreements have deferral clauses and minimum employment clauses meant to mitigate investor risk. See sources cited *supra* notes 31, 32, and 46 and accompanying text; see also Fantex, Inc., *supra* note 1, at 6 (two-year minimum period of NFL activity).

## 1. The Corporate Equity Analogy

A frequently heard claim is that ISAs resemble corporate equity, a de facto incorporation of humans.<sup>197</sup> News articles and blog posts proclaim that “[n]ew crowdfunding platforms let you sell stock in yourself” and speak of “how normal people are becoming corporations.”<sup>198</sup> Equity characterization of ISAs can also be found in the academic literature: Friedman and Kuznets characterized human capital contracts as sales of stock in humans, and other scholars have noted this characterization as well.<sup>199</sup> Just as commentators raising slavery and servitude concerns likely do not mean that ISAs literally replicate historical slavery, those who make a corporate analogy understand that humans have not actually been incorporated.<sup>200</sup> Rather, the imagery of incorporating a human captures an overall sense that an ISA may allocate, via financial contract, ownership claims in a human in a manner reminiscent of how stock divides up ownership of a “corporate” person.

More precisely, the corporate equity analogy draws a parallel to corporate finance, in which businesses raise capital by either borrowing (i.e., debt financing) or by issuing shares in exchange for a capital contribution (i.e., equity financing). Despite their common purpose, debt and equity are treated differently under the law. Equity suggests ownership of the enterprise as opposed to a mere creditor relationship. An equity owner generally is understood to have not only an interest in the upside of business performance but also greater exposure to the downside of business failure.<sup>201</sup> Debt holders have rights to get repaid

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197. See, e.g., KOLLIN & KOLLIN, *supra* note 11; Schwartz, *supra* note 4 (manuscript at 2:59–3:59).

198. Adrienne Jeffries, *New Crowdfunding Platforms Let You Sell Stock in Yourself* (Feb. 26, 2013, at 2:30 PM), <http://www.theverge.com/2013/2/26/4031938/new-crowdfunding-platforms-let-you-sell-stock-in-yourself>, archived at <http://perma.cc/7XYJ-CMQF>; Kevin Roose, *The IPO of You and Me: How Normal People are Becoming Corporations*, THE VERGE (Nov. 19, 2013, 9:05 AM), <http://nymag.com/daily/intelligencer/2013/11/ipo-of-you-and-me.html>, archived at <http://perma.cc/SJ28-Y7U4> (“What do Twitter, Berkshire Hathaway, and your best friend Dave have in common? Pretty soon, you might be able to buy stock in all three.”); see Alison Griswold, *Because You’re Worth It* (Apr. 10, 2014, 2:28 PM) [http://www.slate.com/articles/business/moneybox/2014/04/income\\_share\\_agreements\\_instead\\_of\\_taking\\_out\\_loans\\_students\\_sell\\_stock.html](http://www.slate.com/articles/business/moneybox/2014/04/income_share_agreements_instead_of_taking_out_loans_students_sell_stock.html), archived at <http://perma.cc/3U7L-DFAY> (“Afraid of student loan debt? Sell stock in yourself instead.”).

199. Friedman & Kuznets, *supra* note 10; Jacobs & van Wijnbergen, *supra* note 86, at 2–4; Schwartz, *supra* note 4 (manuscript at 2:59–3:59).

200. See sources cited *supra* note 199.

201. See, e.g., *Comm’r v. O.P.P. Holding Corp.*, 76 F.2d 11, 12 (2d Cir. 1935):

The shareholder is an adventurer in the corporate business; he takes the risk, and profits from success. The creditor, in compensation for not sharing the profits, is to be

irrespective of how the business is performing while equity owners do not.<sup>202</sup>

Within the corporate equity rubric, it is possible to refine our thinking further. Extending the analogy, a human could be characterized as issuing (1) an equity-like stake akin to certain types of preferred shares (i.e., generally, seniority in repayment and a prenegotiated dividend amount, but no voting or control rights) in her entire self, or (2) an equity-like preferred stake in a specific enterprise that she has undertaken. The first construction most closely captures the view that the new transactions approximate the incorporation of humans, as opposed to the de facto interposition of a corporate entity between the individual and the enterprise she is conducting.

Despite its intuitive appeal, the corporate equity analogy may not be satisfactory in some cases. First, the economics of the transaction might not suggest equity characterization. Some interests may be so protected from risk that they are effectively debt, not equity.<sup>203</sup> Second, corporate dividends are not necessarily guaranteed. By contrast, in the ISA context, the income share *must* be paid to the funding provider. Third, other indicia of corporate equity may be absent, such as voting rights, low bankruptcy priority compared to debt, or limited liability. Finally, there may be no actual entity interposed between the investor and the funding recipient.

Ultimately, the corporate equity analogy may make the most sense in cases where (1) funds have been raised to support the funding

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paid independently of the risk of success, and gets a right to dip into the capital when the payment date arrives.

*See also* Crawford Drug Stores, Inc. v. United States, 220 F.2d 292, 295–96 (10th Cir. 1955) (“[I]t is a common attribute of a debt that the holder thereof is entitled to interest thereon even though there are no net earnings. But in ordinary circumstances the holder of preferred stock has no such absolute right to the payment of dividends.”); I.R.S. Chief Counsel Adv. Mem., CCA 200134004, 2001 WL 961299 (Aug. 24, 2001) (“One general difference between equity and debt is that an equity holder’s profit or loss depends on the success of the business venture, whereas a debt holder is entitled to his return without regard to the success of the business.”); JOINT COMMITTEE ON TAXATION, JCX-41-11, PRESENT LAW AND BACKGROUND RELATING TO TAX TREATMENT OF BUSINESS DEBT 15 (July 11, 2011), available at <https://www.jct.gov/publications.html?func=showdown&id=3803>, archived at <https://perma.cc/9WK3-M7GY>.

202. There are other legal consequences associated with holding debt as opposed to equity; a corporation generally owes fiduciary duties to shareholders not owed to bondholders except in cases of fraud, insolvency, or illegality. *Simons v. Cogan*, 549 A.2d 300, 302–03 (Del. 1988). Debtholders enter into different covenants than shareholders. Holders of debt, even convertible debt, also generally do not have rights to bring a derivative action. *Harff v. Kerkorian*, 324 A.2d 215, 219 (Del. Ch. 1974). *But see Hoff v. Sprayregan*, 52 F.R.D. 243, 247 (S.D.N.Y. 1971) (convertible subordinated debenture holders had standing to sue in a derivative action); *cf.* N. Am. Catholic Educ. Programming Found. v. Gheewalla, 930 A.2d 92, 94 (Del. 2007) (noting that in Delaware, debtholder had rights to bring derivative action where corporation was insolvent).

203. *See* sources cited *supra* notes 201–02 and accompanying text.

recipient's business venture, as opposed to, say, the funding recipient's education; and/or (2) an intermediate entity actually plays a key role in the arrangement.

## 2. The Partnership Interest/Joint Venture Analogy

ISAs may also be analogized to joint ventures or partnerships. The difference between the partnership/joint venture analogy and the corporate equity analogy is that the former does not attempt to interpose a corporate entity or posit de facto incorporation of the human. In a partnership or joint venture, the parties associate to carry out a business enterprise for profit, combining their skill, knowledge, money, and/or property to that end.<sup>204</sup> While joint ventures and partnerships are not completely synonymous, they are overlapping categories without a clear distinction.<sup>205</sup> Joint ventures are usually more limited than partnerships in scope, purpose, and duration.<sup>206</sup> Yet, partnership law usually governs joint ventures.<sup>207</sup>

The partnership/joint venture analogy leads to various legal and regulatory insights. In tax law, for example, a finding that an arrangement is in substance a partnership for tax purposes generally leads to a pass-through taxation regime with complex rules.<sup>208</sup> In corporate law, while a corporation provides limited liability for the owners of the corporation, a common law general partnership will not

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204. *Comm'r v. Culbertson*, 337 U.S. 733, 742 (1949):

[A Partnership exists when] considering all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intend to join together in the present conduct of the enterprise.

UNIF. P'SHIP ACT § 101(6) (1997); 46 AM. JUR. 2D *Joint Ventures* § 1 (2014); 106 AM. JUR. PROOF OF FACTS 3D 351 § 1 (2009) (describing partnership as “a combination of two or more persons of their property, effects, labor, or skill in a common business or venture, under an agreement to share the profits or losses in equal or specified proportions”).

205. *Nat'l Bank of Commerce v. HCA Health Servs. of Midwest, Inc.*, 800 S.W.2d 694, 697 (Ark. 1990) (stating that a joint venture must have elements of partnership); *Weiner v. Fleischman*, 816 P.2d 892, 895 (Cal. 1991) (“The distinction between joint ventures and partnerships is not sharply drawn.”); 46 AM. JUR. 2D *Joint Ventures* § 5; 48A C.J.S. *Joint Ventures* § 3 (“The divergence between the two relations is still very slight and is difficult to ascertain in some circumstances.”).

206. 46 AM. JUR. 2D *Joint Ventures* § 5 (“[T]he principal difference between a partnership and a joint venture is that a partnership is ordinarily formed for the transaction of a general business, while a joint venture is usually limited to a single transaction.”).

207. 48A C.J.S. *Joint Ventures* § 3.

208. *See infra* Part V.B.1 (discussing characterization as a partnership and the resulting tax implications).

necessarily provide comparable protection for its partners.<sup>209</sup> In addition, the partnership/joint venture analogy may hold different nuances as a policymaking heuristic than the corporate analogy. Corporate equity connotes ownership and control, while a partnership analogy may tend to suggest a more cooperative advancement of a shared goal between the capital-providing partner and the services partner. Thus, analogizing to a partnership/joint venture relationship may lead to a more sanguine evaluation of ISAs.

Yet, the partnership/joint venture analogy also poses conceptual challenges. As with the corporate equity analogy, it is unclear whether the underlying asset or enterprise is a circumscribed activity or the funding recipient herself. Two distinct variants are possible: (1) a partnership or joint venture arrangement between capital-providing partners and the funding recipient (as primarily a services partner) in the venture of her “life,” or (2) a partnership or joint venture arrangement between capital-providing partners and the funding recipient (as primarily a services partner), in which the venture is a circumscribed set of activities (e.g., football activities or a specific business venture). The first variant stretches our notion of partnership to a greater extent than the second.<sup>210</sup>

Notably, the element of joint enterprise may be missing in some ISAs. For example, the funding providers may not be able to force the funding recipients to pursue certain careers or activities.<sup>211</sup> Under common law, both partnership and joint venture arrangements generally feature an element of joint control.<sup>212</sup> On the other hand, in limited partnerships, some limited partners may not necessarily exercise control over the business.<sup>213</sup> In sum, despite conceptual

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209. The increase in available entity options, including LLCs, LLPs, and LPs, along with electivity of pass-through tax treatment, has diminished some of these differences. *See, e.g.*, Heather M. Field, *Checking in on “Check-the-Box,”* 42 LOY. L.A. L. REV. 451, 524 (2009); Susan Pace Hamill, *The Origins Behind the Limited Liability Company*, 59 OHIO ST. L.J. 1459, 1519–21 (1998).

210. This is especially so because “traditional” partnerships would be treated as separate entities for some purposes, for example, when entering into contracts with other parties. The first variant makes it more difficult to identify the “entity” in the ISA parallel.

211. *But see* Fantex, Inc., *supra* note 1, at 25.

212. A joint venture generally requires (1) an agreement to carry on the enterprise for profit; (2) evidence of an intent to be joint venturers; (3) contribution by each venturer of property, money, skill, or effort; (4) some joint control over the venture; and (5) provision for sharing of profits and losses. 46 AM. JUR. 2D *Joint Ventures* § 8 (2014). A partnership generally requires (1) the intent to be partners; (2) coownership of the business (including control over the business and profit and loss sharing); and (3) a profit motive. 106 AM. JUR. PROOF OF FACTS 3D 351 § 8 (2009).

213. *See generally* Carter G. Bishop, *The New Limited Partner Liability Shield: Has the Vanquished Control Rule Unwittingly Resurrected Lingering Limited Partner Estoppel Liability as Well as Full General Partner Liability?*, 37 SUFFOLK U. L. REV. 667 (2004) (describing history of

challenges (such as the lack of a separate legal entity), it is conceivable that the partnership/joint venture analogy may turn out to be the closest analogy for at least some ISAs, particularly ones that are strictly peer-to-peer, more informal, and more interactive.

### 3. “Equity in Disguise” (i.e., Nonequity)

Finally, ISAs resemble some arrangements that are not really equity at all. The following are some of the key possibilities.<sup>214</sup>

#### *a. Insurance*

Some ISAs may resemble insurance or risk-pooling arrangements, which are traditionally entered into to smooth consumption or earnings shocks. Insurance is, broadly speaking, the transfer of risk from an insured to the insurer in exchange for a price or premium.<sup>215</sup> Many types of risks may be insured against, and a variety of arrangements may be characterized as insurance. For example, consumer bankruptcy is commonly characterized as a form of social insurance against economic distress.<sup>216</sup> Procedures for requesting forbearance from tax collection may also be characterized as a form of social insurance.<sup>217</sup> Insurance arrangements usually contain the elements of risk diversification and risk pooling: the insurer diversifies against the risk assumed by aggregating the risks of many into an actuarially sound insurance pool.<sup>218</sup> The dual asymmetric information

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limited partner control rule and its elimination under the Uniform Limited Partnership Act of 2001, § 303).

214. In addition to the categories we describe, ISAs may also be reminiscent of other arrangements we have not discussed, such as apprenticeship arrangements, syndicates, contracts for services, and sales of body parts. *See generally, e.g.*, STEPHEN F. HAMILTON, APPRENTICESHIP FOR ADULTHOOD: PREPARING YOUTH FOR THE FUTURE 153–86 (1990) (arguing for an “American-Style Apprenticeship System”).

215. 43 AM. JUR. 2D *Insurance* §§ 1–3 (defining the characteristics of insurance); ALLAN HERBERT WILLET, THE ECONOMIC THEORY OF RISK AND INSURANCE 71–73 (1951).

216. Adam Feibelman, *Defining the Social Insurance Function of Consumer Bankruptcy*, 13 AM. BANKR. INST. L. REV. 129, 131 (2005) (noting “the general agreement that consumer bankruptcy functions at least partly as a form of social insurance”); Richard M. Hynes, *Why (Consumer) Bankruptcy?*, 56 ALA. L. REV. 121, 153 (2004) (consumer bankruptcy “provides the consumer with a form of insurance that the consumer failed to purchase due to some form of market failure”). Under this conception, the pool of insureds is everyone eligible to file for consumer bankruptcy, the insurance premium is extracted by imposition of higher interest rates, and the payout comes in the form of debt forgiveness.

217. *See* Shu-Yi Oei, *Who Wins When Uncle Sam Loses? Social Insurance and the Forgiveness of Tax Debts*, 46 U.C. DAVIS L. REV. 421, 462–70 (2012).

218. WILLET, *supra* note 215, at 72 (“Wherever there is accumulation for uncertain losses, or wherever there is a transfer of risk, there is one element of insurance; only where these are joined with the combination of risks in a group is the insurance complete”).

concerns of adverse selection (the worry that only risky people will purchase insurance) and moral hazard (the worry that insureds will behave badly because they feel protected against risk) are features of most insurance schemes.<sup>219</sup>

In addition to drawing parallels to equity, the financial press has characterized Fantex as insurance for the athlete against future injury or disability. The insurance payout comes in the form of a guaranteed sum up front, and the premiums are calculated as a percentage of future NFL earnings.<sup>220</sup> Such insurance characterization is buttressed by the fact that the amount of insurance “purchased” seems to vary based on the riskiness of the position played.<sup>221</sup> The Fantex transaction exhibits the potential for adverse selection and moral hazard common to insurance transactions—specifically, that (1) only risky football players would do the deal, and (2) the athletes might behave badly (e.g., by taking excessive risks on the field, accepting less pay, or quitting) because they feel protected against risk.

Other ISAs may also approximate insurance. Students and entrepreneurs may, for example, use ISAs to protect themselves against the risk of career failure, the risk that a decision to pursue education does not reap the expected returns, or the risk that a bankruptcy filing will result in a nondischargeable student loan debt.<sup>222</sup> Moral hazard and adverse selection issues will also be present in these contexts.

Framing these arrangements as insurance may cast them in a more positive light than analogizing them to equity. However, the insurance analogy also has limits. Depending on the transaction’s

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219. See generally Ronen Avraham, *The Economics of Insurance Law—A Primer*, 19 CONN. INS. L.J. 29, 34, 42–45 (2012) (discussing the informational concerns and moral hazards).

220. See *supra* note 142. The transaction does contain a claw-back provision. See, e.g., Fantex, Inc., *supra* note 1, at 165.

221. For example, among the initial deals pursued by Fantex was an offering on Arian Foster, a Houston Texans running back. Foster opted to monetize twenty percent of his future earnings. See Erik Matuszewski, *Fantex Postpones Arian Foster Share Sale Because of Back Surgery* (Nov. 13, 2013), <http://www.bloomberg.com/news/articles/2013-11-12/fantex-postpones-arian-foster-share-sale-because-of-back-surgery>, archived at <http://perma.cc/2ZG7-MPRJ>. In contrast, Vernon Davis, a San Francisco 49ers tight end, opted to monetize only ten percent. *Explore Stocks*, *supra* note 22. According to NFL-based statistics, the running back position is physically more risky than that of tight end. Matt Stiles, *Charting NFL Injuries*, THE DAILY VIZ (March 17, 2013), <http://thedailyviz.com/2013/03/17/charting-nfl-injuries/>, archived at <http://perma.cc/V6J4-KH3A>. Foster’s offering was ultimately suspended due to back surgery. See Matuszewski, *supra*. Although riskiness of player position may have been an initial factor in selecting monetization rates, the current offerings (covering players in several different positions) are all at ten percent, with the exception of wide receiver Alshon Jeffery at thirteen percent. See *Explore Stocks*, *supra* note 22.

222. Students may be managing risk by entering into these agreements in order to convert nondischargeable student loan debt into a debt that is dischargeable in bankruptcy. See 11 U.S.C. § 523(a)(8)(A) (2012) (excepting student loans from discharge provisions).

economics, it is possible that risk transfer has not actually occurred.<sup>223</sup> Also, the consumption-smoothing aspect of insurance arguably is more questionable with ISAs because the insurance payout comes up front, before the risks being insured against have materialized.<sup>224</sup> Perhaps most importantly, while ISAs may change the allocation of risks, current ISA structures do not generally *pool* risk.<sup>225</sup> For example, risk is being transferred to the purchasers of Fantex shares, but such shareholders may not be diversifying their risks by investing in many athletes.<sup>226</sup>

However, there is nothing to stop investors from pooling risk, for example, by purchasing other types of investments. Furthermore, to the extent that funding is not sought to develop a commercial enterprise but rather to smooth shocks, the arrangement may be credibly described as insurance-like.

Thus, whether the insurance analogy is apt will depend on the economics—particularly the risk diversification and pooling features—of the specific transaction. If an ISA can be fairly characterized as insurance, this may suggest a certain set of regulatory consequences, such as being subject to the jurisdiction of insurance regulators.

#### *b. Sale of an Income-Generating Asset or Income Stream*

ISAs may also be likened to a sale of an income-generating asset or rights to future income, such as an account receivable, an intangible, or some other type of future income stream. An individual might do this to accelerate cash receipts. For example, a funding seeker who is reasonably certain he will receive \$50,000 a year of royalties for the next two years but who needs immediate payment might be able to accelerate that income stream at a suitable discount rate in exchange for a current lump sum.<sup>227</sup> The analogy to sales of a receivable or right to future income may be most apt when the time period for income sharing is not very long or where the source and amount of the repayments is quite certain.

If an ISA were analogized to such a sale or an assignment of income, then the regulatory consequences might differ from that accorded to an equity-like or debt-like arrangement. For example, the

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223. For example, insurance may simply not have occurred to the funding recipients.

224. In Fantex, the athletes receive their funds upfront and regardless of actual injury or sports or commercial success. See *supra* Part II.A.1.

225. See WILLETT, *supra* note 215, at 72.

226. See *supra* Part II.A.1.

227. This is essentially the nature of the Bowie Bond transaction. See *supra* Part II.B.3.



asset sold might escape inclusion in a bankruptcy estate.<sup>228</sup> The tax consequences of a sale would also be different from that accorded an equity or debt issuance.<sup>229</sup>

*c. Gift, Donation, and Subsidy*

Finally, while some ISAs are designed to ensure that investors earn a certain return, others may be designed with a less profit-oriented motivation. For example, transactions offered by nonprofits or the government may be designed with the understanding that the funding provider may not necessarily recover its full investment or may recover no more than its principal.<sup>230</sup> Such transactions may look less like equity or a sale and more like a gift, subsidy, or charitable donation. Particularly with respect to government-backed arrangements but also potentially with some nonprofit transactions, ISAs may be a form of social redistribution. It is likely that we will regard transactions that look like gifts, donations, or subsidies differently from those in which investors earn a profit, both in terms of normative evaluation and legal treatment.

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The challenge confronting us is how to determine our normative attitudes and regulatory approach towards ISAs. In Part III, we argued that the work of comparison and analogy can help accomplish both tasks. First, comparing and analogizing ISAs to more familiar arrangements can serve as a heuristic for normative evaluation. Second, the predominant characteristics of a given ISA and its comparability to familiar regulatory categories should suggest the appropriate approach to its regulation.<sup>231</sup> In general, an ISA should be regulated similarly to the existing category to which it is most analogous, unless there is a good reason to deviate. This allows economically similar transactions, particularly those that are close

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228. See, e.g., Thomas J. Gordon, *Securitization of Executory Future Flows as Bankruptcy-Remote True Sales*, 67 U. CHI. L. REV. 1317, 1318 (2000) (describing how to keep a securitized asset out of a bankruptcy estate by structuring it as a true sale).

229. Compare I.R.C. § 1001 (2012) (defining gain and loss for sales), and § 1221 (defining capital assets to exclude stock in trade of the taxpayer), with § 351 (recognizing no gain or loss if property is transferred in exchange for stock). For example, such a sale might implicate the assignment of income doctrine.

230. This is arguably the case with 13th Avenue Funding and Lumni's nonprofit funds. See *supra* Parts II.A.4.a and II.A.4.b.

231. See *supra* Part III.B and C.

substitutes, to be treated similarly.<sup>232</sup> Conversely, a wholesale approach that groups all ISAs together and regulates them in a monolithic fashion is likely to be overinclusive, underinclusive, or poorly tailored.

#### IV. A MULTIFACTOR FRAMEWORK FOR REGULATION

How might regulators determine the categories to which ISAs are most analogous? Part IV articulates a multifactor framework that may be employed across a number of regulatory fields in making this determination. Multifactor tests are a well-established regulatory tool in a number of fields. A multifactor analysis may be applied in cases where regulators are seeking to determine how a new transaction should be categorized and labeled for purposes of regulating the activity. In particular, this method can play an important role where transactions or contractual arrangements have features of more than one analytical or regulatory category.<sup>233</sup> A multifactor analysis tailored to address the distinctive issues raised by these transactions is a particularly appropriate mode of analysis in the case of ISAs because it is sensitive to the heterogeneity of ISAs and the various regulatory fields that may potentially govern them.

##### *A. Should a Transaction Be Treated as Debt?*

The first step is to determine whether a seemingly new transaction is actually new or whether it is simply a type of contingent debt. It makes sense to ask this threshold question because debt is a familiar regulatory construct with respect to the financing of individuals. The question is whether an ISA has enough in common with debt that it can fit snugly in the debt “box” and be regulated accordingly.

Weighing a list of factors can help make this determination. In the ISA context, the following factors would suggest that an arrangement is similar enough to debt that we should strongly consider regulating it as such. It is important to reiterate that there is no expectation that precisely the same list of factors would be applied in all regulatory fields to test the ISA’s similarity to debt. However, given

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232. *See supra* Part III.A.2.

233. For example, a multifactor analysis is used to distinguish debt from equity in the tax and bankruptcy contexts. *E.g.*, *Indmar Prods. Co. v. Comm’r*, 444 F.3d 771, 776–77 (6th Cir. 2006); *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 696 (3d Cir. 1968) (citing *J.S. Biritz Constr. Co. v. Comm’r*, 387 F.2d 451 (8th Cir. 1967)); *Idaho Dev., LLC v. Teton View Golf Estates, LLC*, 272 P.3d 373, 377–78 (Idaho 2011). The list of factors differs among courts, and courts have generally recognized that no single factor is determinative.

that debt instruments have certain core features irrespective of the regulatory field doing the analysis, we anticipate that the following factors would be relevant in multiple fields:

Intent of the parties. The parties' intent, as manifested by objective factors such as the funding provider's expectation of repayment, the instrument label, the financial viability of the funding recipient, and the recipient's likely ability to repay principal plus interest, should be considered.

Form of the instrument. For example, the existence of a fixed term, an unconditional promise to pay, and remedies upon default would indicate a debt instrument.

Whether the interest rate is fixed. A fixed interest rate would tend to indicate debt.

Duration of the instrument and existence of a fixed maturity date. A fixed maturity date is indicative of debt, and a longer duration is indicative of equity because the holder takes on more risk over a longer time period.

Extent of subordination to claims of creditors. Subordination to other debts in repayment priority indicates an equity interest.

Allocation of the risk between parties. To the extent the funding provider is insulated against the risk of low earnings or loss of principal—for example, by virtue of minimum payments, earnings floors, or term deferrals—the agreement looks more like debt, in which repayment of principal is required.<sup>234</sup>

Participation in management. A greater degree of participation in management suggests an equity or ownership investment, rather than a mere creditor interest.

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234. See, e.g., *TIFD III-E, Inc. v. United States (Castle Harbour)*, 459 F.3d 220, 231 (2d Cir. 2006) (“[T]he Dutch banks’ interest was overwhelmingly in the nature of a secured lender’s interest, which would neither be harmed by poor performance of the partnership nor significantly enhanced by extraordinary profits. The banks had no meaningful stake in the success or failure of Castle Harbour.”).

If a weighing of these and other relevant factors by a regulatory regime suggests that a given ISA sufficiently resembles debt to be treated as such, then the existing legal framework in that field for regulating debt can be applied to the ISA.

This is not to say that ISAs may not raise fresh challenges or that our current approach to the regulation of debt is optimal. We make no claim that existing legal treatment of debt in bankruptcy, tax, consumer protection, bank regulation, or other areas is ideal, rational, or sufficient. In particular, the adequacy of current approaches to the regulation of consumer debt has been subject to scrutiny.<sup>235</sup> Our more basic point is that if ISAs can be subsumed under the rubric of debt, then these questions can be addressed under the general umbrella of lending regulation and reform. New categories need not be created. Thus, for example, an ISA ultimately characterized as debt by a state based on an analysis of factors would typically face that state's usury law limitations on the interest rate and terms permitted. A debt designation also more clearly suggests a role for the Consumer Financial Protection Bureau in the regulation of these new agreements.

### *B. Is it Too Much Like Human Ownership?*

If the ISA is not debt, then it could either fall within the equity-like gray zone or, alternatively, could come too close to human ownership. Thus, we should next examine the possibility that it creates a problematic ownership or property-like interest in a human that ought to be restricted, in order to eliminate that possibility. The presence of four factors in particular would strongly suggest that a contract too closely approximates human ownership:

Excessive duration of the contract. A contract that called for payments over a longer period of time would suggest human ownership more than one lasting, say, five years.

Too large a percentage of income encumbered. A contract sharing a large percentage of income would look more like ownership than one sharing a small percentage.

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235. Questions regarding financial product regulation have arisen in the context of articulating the mission of the Consumer Financial Protection Bureau. *See generally* Bar-Gill & Warren, *supra* note 15; Richard Cordray, Protecting Consumers in the Financial Marketplace: Keynote Address, November 2, 2012, 2013 U. CHI. LEGAL F. 1; Daniel Carpenter & Patricia A. McCoy, *Keeping Tabs on Financial Innovation: Product Identifiers in Consumer Financial Regulation*, 18 N.C. BANKING INST. 195 (2013).

Too much control over funding recipient's labor, investment, and personal choices. The more control exercised by the investor, whether formally or through informal mechanisms and networks, the more an agreement might look like servitude or ownership.

Too broad a base for income sharing. An agreement that shares income from a specific business activity, investment, or job intrudes less on a recipient's self-determination than one that shares a percentage of *all* the individual's income.

For example, based on these factors, a contract that encumbers eighty percent of the funding recipient's income over thirty years and in which the funding provider has the power to direct the recipient's career choices (such as a provision that the recipient must work in the financial services industry for X years) would too closely approximate servitude or slavery. Depending on the specific context, an ISA need not have all four factors to trigger policy concerns and potential invalidation. Ultimately, the analogy between an ISA and an impermissible slavery/servitude arrangement will be a function of weighing the four factors and determining how they infringe upon the funding recipient. A finding that an ISA strongly resembles human ownership might suggest that we should put in place regulatory structures that ban or circumscribe such ISA variants.

### *C. Regulating in the Equity-Like Gray Zone*

If an ISA is not sufficiently analogous to traditional debt from the perspective of a particular regulatory field to warrant the debt label, but the ISA also does not rise to the level of human ownership or indentured servitude to warrant serious government intervention, then it must fall in the messy gray area of financial instruments that have some equity-like features. As discussed in Part III.C, possible analogies include corporate equity (either in the whole person or in a circumscribed venture), partnership or joint venture (again either in the person or in a venture), insurance, income assignments, gifts, or subsidies.<sup>236</sup> The regulatory question is what legal rules should apply to ISAs falling within this messy gray zone, with respect to protection and treatment of both investors and funding seekers. The task is

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236. See discussion *supra* Part III.C; see also *supra* note 214.

complicated by the fact that there may be significant differences among ISAs, and these differences may demand different regulatory approaches.

We suggest that the following factors might be considered in determining where exactly in the gray zone a given ISA falls and, thus, what rules should apply. As before, there is no expectation that each regulatory field will use precisely the same set of factors to make this determination. Additional factors may be relevant in a specific field. However, given that these regulatory fields generally confront a common array of financial arrangements, we anticipate that the following factors would be relevant across most regulatory fields in evaluating “gray zone” transactions. None of the proposed factors below would be determinative, and the regulator’s ultimate conclusion will depend on the totality of the circumstances, determined by weighing the relevant factors.

Interposition of a Corporate Entity. First, it is relevant whether a corporate or other entity has been interposed between the funding provider and the funding recipient. This can help distinguish, analytically speaking, between whether a corporate equity interest or a partnership/joint venture interest has been created. The existence of an intermediate entity (such as that interposed in the Upstart transaction) is more likely to suggest corporate equity.

Base for Sharing Income. As was the case in testing for servitude or slavery, the income sharing base must continue to be considered. If the income sharing base is the funding recipient’s total income (Line 22), the arrangement may look more like a minority corporate- or partnership-like equity stake in an individual herself, rather than in a circumscribed venture undertaken by that individual. If, alternatively, the income sharing base is only income from a circumscribed set of activities (e.g., a discrete business), then the transaction may more closely approximate an equity-like interest in a circumscribed venture or a sale of that income stream. While this factor does not help distinguish between corporate and partnership/joint venture equity, it can help differentiate between equity in a venture and equity in a person and may also suggest a sale of an income-producing asset.

### Funding Provider's Expected Return on the Investment.

The degree to which the funding provider expects to earn a return on her investment must also be considered. Some ISAs are based on economic models that attempt to ensure a certain rate of return. However, an agreement could also be structured so that the funding provider does not earn a profit (e.g., federal income-contingent student loan repayment programs or nonprofits like Lumni and 13th Avenue).<sup>237</sup> Transactions structured so that the funding provider does not make a profit may suggest an element of gift, charitable donation, or subsidy rather than equity ownership. Transactions in which the return is essentially fixed may indicate a sale of an income-producing asset. The following are some factors that might reveal the expected return on an investment: the extent of the recipient's other borrowing, the amount funded as compared to the repayment terms, the estimated future earning potential of the recipient, and the fund or startup's investment return history.

Funding Provider's Intent. It is also important to consider the funding provider's intent as manifested by objective factors. This can help distinguish equity-like investments from arrangements with donative motivations. For example, if the terms of the agreement show that the funding provider's intention is to make a substantial profit, this would detract from gift or subsidy characterization, even if no profit is ultimately made. On the other hand, if the formal and informal terms indicate that mentoring between the funding investor and recipient is the primary motivation, this may suggest more strongly a gift or donation, despite an eventual profit. For example, 13th Avenue Funding's nonprofit model is reminiscent of informal arrangements in which a community pools resources to send its promising youth to school. Thus, it might seem inappropriate to characterize 13th Avenue as equity and to regulate it in a manner identical to a transaction like Upstart.

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237. See discussion *supra* Part II.A (discussing Lumni, 13th Avenue, and government transactions).

Identity of the Funding Provider. The identity of the funding provider must also be considered. From a commercial and regulatory perspective, there may be important differences between government-based and not-for-profit financing arrangements and those arising in the private sector. Private-sector transactions are generally expected to provide a market return to investors and may look more like equity.<sup>238</sup> This may be less so with nonprofit, low-profit, or government models, where a significant gift, subsidy, or redistribution element may dominate. It is more difficult to characterize such agreements as equity, and it is correspondingly unlikely that a unified regulatory scheme could effectively govern all of the possible types of players in this growing sector.

Funding Recipient's Application of the Funds. Another factor is how the funding recipient applies the funds. To the extent the funds are used for risk management rather than to fund a business venture, pay education costs, or otherwise generate income for the recipient, the investment may be less like a partnership or corporate equity-like interest and more like insurance and risk diversification.

Whether Human Capital is Appreciating or Depreciating. Whether the recipient's human capital is appreciating or depreciating may influence the choice between insurance and equity characterization. For example, in the education context, the funding recipient's human capital is presumably appreciating. In contrast, in the professional football context, the player's human capital is arguably depreciating or at risk. Contexts in which human capital is depreciating may suggest an insurance or earnings-smoothing arrangement more than an equity-like arrangement, particularly if the funding recipient is not using the funds to advance his income-earning potential or business venture but to guard against risk.

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238. Thus, these new transactions do not necessarily make college cheap.



Whether Risk is Being Pooled. The existence of risk pooling would strongly suggest insurance.<sup>239</sup> Existing ISAs have not generally created a pool for diversifying against risk. One might argue that risk is effectively being spread among the multiple funding providers, but this structure is different from traditional insurance. An indication that there is pooling of risk would buttress a true insurance characterization.

Whether the return is dependent on a specified asset expected to generate a certain return. Finally, we must consider whether the return to the investor is generated from a specified asset and whether that return is relatively certain. If so, the arrangement may more closely approximate a sale of an income-producing asset rather than equity or something else.

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The foregoing are some of the main factors that should be considered by regulators in bankruptcy, tax, securities, and other fields in determining where in the equity-like gray zone a given transaction falls. As indicated, our list is not necessarily exhaustive, and other factors may also be useful. Furthermore, the factors analysis we have put forth is necessarily generic and essentially constitutes a generalized prototype approach that may be modified and adjusted by each regulatory field. Ultimately, these factors would need to be weighed against each other to determine the true nature of the ISA based on the totality of the circumstances.

Ultimately, the exercise of comparison and analogy through multifactor analysis can serve as an evaluative heuristic in considering the normative aspects of each particular ISA. It also can suggest the likely best approach to that ISA's regulation.

## V. APPLYING OUR MULTIFACTOR FRAMEWORK

This Article has argued that ISAs are sufficiently novel that they merit scrutiny by regulators but are heterogeneous enough that a unified regulatory approach is problematic. As such, this Article has advocated regulation by analogy for ISAs using a multifactor analysis. Although the precise set of factors examined by each regulatory field in

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239. See *supra* Part III.C; see also *supra* note 223 and accompanying text.

performing this inquiry would likely be adjusted for the specific needs of the field, we expect that certain core factors will be relevant across most regulatory areas.

Part V illustrates the application of our proposed multifactor analysis. Parts V.A and V.B apply our multifactor analysis to the Pave ISA transaction,<sup>240</sup> concluding that while the analogy is not perfect, Pave may look enough like a partnership that we should look to partnership concepts in designing its legal and regulatory treatment unless important policy considerations suggest otherwise.<sup>241</sup> Part V.C examines the Rubio-Petri proposed legislation as an illustration of the perils of a unified approach to ISAs.

### *A. Applying the Analysis to Pave*

Applying the multifactor analysis to Pave, we first ask whether Pave looks sufficiently like debt to fit into that familiar regulatory category. As noted, each regulatory field would make that determination itself. However, a core cluster of factors (which we identified in Part IV and apply here) would likely be broadly relevant. We then examine the other extreme—the possibility that Pave could look enough like servitude or slavery to justify restriction. Concluding that Pave is clearly distinct from debt and does not amount to servitude, we examine where in the gray zone Pave falls.

#### 1. Is Pave Analogous to Traditional Debt?

Testing the Pave transaction using the factors outlined in Part IV.A, it would be hard to characterize Pave as debt. Of the seven factors, four clearly suggest that the transaction is not debt, and two are neutral or lean slightly away from debt characterization. Only one potentially suggests debt characterization.

The parties' intentions and the label, given the transactions, the form of the instrument, the lack of a fixed interest rate, and the allocation of risk, suggest that the transaction is not debt:

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240. As noted, it is unclear whether Pave's ISA has been replaced by a new loan product as of August 2014. See discussion *supra* note 39. However, the Pave ISA still merits analysis as a leading example of the new wave of ISAs. Moreover, Pave ISAs that were entered into prior to August 2014 still exist and continue to raise tax and other regulatory questions.

241. Our discussion is based on information that has been made available on the Pave website. See, e.g., *Common Questions*, PAVE, <https://web.archive.org/web/20121216014602/http://pave.com/questions>, archived at <http://perma.cc/79UX-T5S4>. The actual Income Linked Payment Agreement is not publicly available.

Parties' intentions/transaction label. Pave's website draws distinctions between Pave's structure and debt with respect to repayment terms and the lender's ability to share upside.<sup>242</sup> Pave has also stated that its "participation agreement is like a partnership, with interests fully aligned for both parties."<sup>243</sup>

Form of the instrument. The absence of an unconditional promise to pay signals that Pave is not debt.

Interest rate/interest payments. Pave's Income-Linked Payment Agreement does not provide for a fixed interest rate or for payment of interest. The funding recipient pays a specified percentage of her total income annually, as calculated on Line 22 of Internal Revenue Service ("IRS") Form 1040.<sup>244</sup> This suggests that Pave's structure is distinguishable from debt.

Risk allocation. Pave's investors bear the risk that recipients will not succeed financially. Recipients may be excused from payment entirely in years when their income falls below 150 percent of the poverty line.<sup>245</sup> Thus, there is no guaranteed minimum return. On the other hand, if the recipient is successful, the investor can receive returns that exceed the rate of return on debt.<sup>246</sup> These terms indicate equity.

Two of the remaining three factors either lean slightly away from debt or are neutral:

Priority relative to other claimants/subordination. The income sharing base is IRS Form 1040 Line 22 income,

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242. *Id.*

243. *Id.*

244. *What Counts as Income when Calculating How Much I Must Share with My Backers*, PAVE, <http://support.pave.com/hc/en-us/articles/200407688--What-counts-as-income-when-calculating-how-much-I-must-share-with-my-Backers-> (May 19, 2014) (on file with authors). If recipient files a joint return, the spouse's income is deducted from the Line 22 income. *Id.*

245. This hardship exemption will not extend the agreement term. *Is There Ever a Time During the Participation Period When I Wouldn't Need to Share Income?*, *supra* note 45.

246. The recipient can terminate the agreement early by repaying five times the amount funded. *Common Questions*, *supra* note 241. This is higher than the three times the amount of income cap in the Upstart transaction. See UPSTART FUNDING AGREEMENT, *supra* note 28 and accompanying text.

which includes business net income. Business net income in turn takes into account business expenses (including allowable business interest) reported on Schedule C. Thus, the funding recipient will first pay business interest and expenses before “sharing” income with the investor. Such subordination of the repayment obligation to the payment of business expenses allows the funding recipient a large degree of discretion and may suggest equity characterization. On the other hand, the repayment obligation is not subordinated to payment of personal interest, so subordination is at best partial.

Duration and fixed maturity date. The Pave agreement term cannot exceed ten years.<sup>247</sup> This time frame is compatible with either equity or debt characterization. Furthermore, while the agreement has a fixed ten-year term, there is no requirement that the investors actually recover their investment within that time frame. Thus, this factor is neutral at best.

Finally, “participation in management” is the only factor that might signal debt rather than equity. Greater degrees of management participation suggest an equity interest. Although mentoring is a component of the Pave relationship, it does not appear to rise to the level of true management control, at least on paper.<sup>248</sup> On the other hand, it is possible that such mentoring may be robust in practice.

In sum, it would be difficult to characterize Pave as debt.<sup>249</sup> Not only do a greater number of factors suggest “not debt” characterization; the *purpose* of the transaction also indicates that it is likely not debt because there is not really an expectation of repayment regardless of whether the funding recipient succeeds.<sup>250</sup> Stated differently, the Pave

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247. See *supra* note 42 and accompanying text.

248. *Common Questions, supra* note 241:

Another major difference is that a Pave agreement has an added value—backers. Many of them are eager to offer guidance, advice and connections in fields relevant to prospects’ interests. With all their experience, backers know that even one phone call or email introduction can make a huge difference to someone who is just starting out in an industry. Also, backer and prospect interests are aligned—the more successful prospects are, the more their backers share in that success.

*How It Works, supra* note 170 (“Backers can choose to provide advice and support throughout the talent’s journey.”).

249. We reached the same basic conclusion with respect to Upstart in prior work. See Oei & Ring, *supra* note 3, at 274–75.

250. TIFD III-E, Inc. v. United States (*Castle Harbour*), 459 F.3d 220, 232 (2d Cir. 2006) (quoting *Gilbert v. Comm’r*, 248 F.2d 399, 406 (2d Cir. 1957)); see also *Historic Boardwalk Hall*,

investors have a “meaningful stake in the success or failure of the [venture].”<sup>251</sup> Thus, not only do the individual factors point away from debt, but it is also clear that the core *purpose* of Pave is one of explicitly sharing in the successes and failures of funding recipients, an ownership or equity-like idea.

## 2. Does Pave Raise Human Ownership or Servitude Concerns?

Having determined that Pave cannot be conveniently slotted into the regulatory category of debt, the next question is whether it creates an unacceptable servitude or human ownership arrangement.

As discussed in Part IV.B, the presence of four factors would strongly indicate that a contract closely approximates human ownership: excessive duration of the contract, a high percentage of income shared, a large degree of investor control, and a broad base for sharing income. Although Pave uses a broad income sharing base (Line 22 of Form 1040), the contract is not unduly long (ten years),<sup>252</sup> nor is the percentage of income shared unduly high (ten percent).<sup>253</sup> Further, the investors do not exercise excessive control over funding recipients. Thus, Pave does not rise to the level of human ownership or servitude that ought to be banned.<sup>254</sup>

## 3. What Kind of Interest Has Been Conveyed by Pave?

Because Pave is not debt and does not cross the line into human ownership, it follows that the transaction must fall in the zone of equity-like transactions. Therefore, we next ask what kind of equity-like interest it most resembles. Closely examining its underlying economics and applying the factors articulated in Part IV.C, we suggest that Pave may be best analogized to a type of partnership between funding providers and recipients in which the funding providers take a partnership interest in the Talent’s human capital.

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LLC v. Comm’r, 694 F.3d 425, 450 (3d Cir. 2012) (explaining the court’s analysis in *Castle Harbour*, 459 F.3d at 224); *Castle Harbour*, 459 F.3d at 232 (a “significant factor” in debt-equity determinations is “whether the funds were advanced with reasonable expectations of repayment regardless of the success of the venture.”).

251. *Castle Harbour*, 459 F.3d at 224.

252. See *supra* note 42 and accompanying text. One could argue that the duration of the ISA term should be compared against Talent’s life or career expectancy in order to more accurately measure excessive duration. On the other hand, a ten-year term is not notably longer (and in some cases may be substantially shorter) than the repayment period for some traditional loan products.

253. *Id.*

254. See Oei & Ring, *supra* note 3, at 275 (reaching comparable conclusion regarding Upstart).

Yet the analogy is not exact. If it were exact, there would not have been any regulatory uncertainty. It is important in pursuing regulation by analogy to appreciate that the “conclusion” the method offers is *not* that an ISA *is*, for example, a partnership but rather that the partnership category might be the closest existing regulatory category. Critiques of regulation by analogy grounded in the argument that an ISA such as a Pave is not a partnership under general partnership principles, or tax or bankruptcy law, misconceive the problem and the solution offered by this Article. Pave is distinct from a traditional partnership because it creates a partnership interest in all of a person’s human capital over a set time period rather than in a circumscribed but potentially indefinite venture. That said, the appeal to Pave’s investors is typically made on the basis of a proposal of a circumscribed business venture or educational plan.

On balance, evaluation of the following factors suggests the creation of a partnership-like arrangement:

Interposition of a corporate entity (distinguishing partnership equity from corporate equity). Pave is a peer-to-peer arrangement.<sup>255</sup> No intermediate entities have been interposed. This is indicative of a partnership rather than a corporate arrangement.

Base for sharing (distinguishing investment in a person v. investment in a circumscribed activity, project, or venture). Pave claims that “[t]he Pave agreement allows backers to invest directly in an individual, not a project or company.”<sup>256</sup> The website notes that “the investment is in whatever work the Talent chooses to pursue” and that “[o]ne failed project doesn’t mean a total loss for the Backer, since the Talent will go on to do something different.”<sup>257</sup> Pave claims that “Backers are allies who share in either the failures or achievements of their Talent.”<sup>258</sup> Such alignment of interests and intent to ally, with the goal of maximizing profits or success, suggest a

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255. See *Tell Me More About Pave’s Income-Linked Payment Agreement (IPA)*, *supra* note 43 (describing Pave as a “truly peer-to-peer agreement that is legally enforceable”).

256. PAVE, *supra* note 152.

257. *How Is Pave Different from Other Crowdfunding Platforms or Financing Alternatives?*, PAVE, <http://support.pave.com/hc/en-us/articles/200398018-How-is-Pave-different-from-other-crowdfunding-platforms-or-financing-alternatives-> (May 19, 2014) (on file with authors).

258. *Id.*

partnership.<sup>259</sup> Pave itself claims that the Pave agreement is “like a partnership.”<sup>260</sup>

Funders’ expected return (distinguishing equity from donative arrangement). Pave explicitly highlights the funders’ expected return, which they calculate to provide Backers “with an expected return . . . of 7%.”<sup>261</sup> Pave also notes its proprietary funding model developed “by our own expert Data Scientist in collaboration with Yale University’s nationally renowned Labor Economist,” which incorporates a wide range of variables.<sup>262</sup>

Investor intent (distinguishing equity from donative arrangement). Pave seeks to market a compelling investment opportunity to investors with a targeted rate of return.<sup>263</sup> This is not a donative arrangement but is more clearly equity.

Identity of the funding providers (distinguishing equity from donative arrangement). Pave is organized by a private, for-profit entity rather than a nonprofit or government entity. The investors it seeks to attract are “experienced, successful professionals” looking for a “direct-investing platform.”<sup>264</sup> These factors suggest equity rather than a donation or subsidy.

Use of the funds—growth v. protection (distinguishing insurance-like structure from equity). Rather than protect against economic shocks, funding recipients use the funds for education or entrepreneurship.<sup>265</sup> Pave emphasizes the “shared venture” nature of its

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259. *See supra* Part III.C.2.

260. *Will I Be Able to Exit the Pave IPA Early?*, PAVE, [\(http://support.pave.com/hc/en-us/articles/200478356-Will-I-be-able-to-exit-the-Pave-IPA-early-\(May-19,-2014\)\)](http://support.pave.com/hc/en-us/articles/200478356-Will-I-be-able-to-exit-the-Pave-IPA-early-(May-19,-2014)) (on file with authors).

261. *What are the Expected Financial Returns?*, *supra* note 48.

262. PAVE, *Our Model*, <http://www.pave.com/funding-model>, archived at <http://perma.cc/M2M2-EM5K> (last visited Mar. 25, 2015).

263. *Id.*; *What are the Expected Financial Returns?*, *supra* note 48.

264. *What Is Pave?*, PAVE, [\(http://support.pave.com/hc/en-us/articles/200597693-What-is-Pave-\(May-19,-2014\)\)](http://support.pave.com/hc/en-us/articles/200597693-What-is-Pave-(May-19,-2014)) (on file with authors).

265. *See supra* Part II.A.3.

arrangement.<sup>266</sup> This indicates that the structure is one of investment, not insurance.

Whether human capital is increasing or decreasing (distinguishing insurance from equity). Pave characterizes itself as a “platform for networking experienced, successful professionals with . . . rising, talented individuals.”<sup>267</sup> Human capital is most likely appreciating, suggesting equity.

Whether risk is being pooled (distinguishing insurance from equity). There is no indication of risk pooling in the traditional insurance sense.<sup>268</sup> This suggests that the arrangement is not insurance.

Whether return is dependent on a specified asset expected to generate a certain return (distinguishing sales of income streams from equity arrangements). The return earned by the investors is a percentage of all the annual income (Line 22, Form 1040) generated by the recipient during the contract years. Neither the amount nor the source is certain at the time of contract. Investors are fully at risk with the funding recipient’s financial success. Thus, Pave is not a sale of a fixed income stream.

Thus, application of these core factors suggests that, on balance, Pave resembles an equity-like arrangement rather than insurance, gift, subsidy, or something else. As between corporate and partnership equity, the better analogy is to a partnership-like arrangement because Pave is peer-to-peer. With regard to the *type* of partnership, the Pave structure more closely resembles an investment in the person and not the project. Again, while we do not claim that the partnership analogy is exact,<sup>269</sup> the likenesses suggest that Pave should be treated similarly to partnerships for legal and regulatory purposes, unless there is a good reason to deviate (as determined under each particular regulatory regime).

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266. See *supra* Part II.A.3.

267. *What Is Pave?*, *supra* note 264.

268. See *supra* Part II.A.3.

269. We could imagine, for example, that depending on certain facts, the transaction may look more like the sale of an income stream, which would invite its own distinctive legal treatment.



It might at first blush appear ludicrous to suggest that Pave is most analogous to a partnership. However, despite arguably “light” control of funding recipients, Pave is not unlike some services-partner arrangements. For example, Pave is not so different from the case where two people decide to partner in opening a vegetable-selling stand, one providing capital and the other labor. One might argue that this arrangement might bear stronger resemblance to an employer-employee relationship or some alternative economic arrangements; however, at least some of these types of arrangements have been held to be partnerships. Moreover, the Pave investors’ interests may be similar to those of some limited partners, who may not have much direction over the enterprise. Additionally, the Pave relationship may have some elements of joint control, which would more clearly indicate a partnership or joint venture.<sup>270</sup> Pave promotes and identifies the Talent’s Backers as the “Team,”<sup>271</sup> and Talent is required to submit a funding proposal to obtain the funds.<sup>272</sup> Having determined that Pave is clearly not debt using the primary factors likely determinative of debt status, it is not that surprising that the closest analogy might be partnership equity.

### *B. Legal and Regulatory Upshot of the Multifactor Analysis*

Assuming that regulators in various fields conclude that Pave most resembles a partnership-like arrangement, what legal and regulatory consequences might follow? While, as noted, the partnership analogy may not be precise, and while the legal and regulatory treatment of “regular” partnerships cannot be interposed without modification on the new ISAs, some insights are possible. An in-depth treatment of all possible legal and regulatory ramifications of the partnership analogy is beyond the scope of this Article. The following discussion very briefly surveys some key takeaways.

#### 1. Taxation

The tax treatment of ISAs must be addressed because taxpayers must make tax computation and return filing decisions annually, regardless of actual tax liability. If an ISA is taxed as a partnership rather than debt, key tax differences will result regarding timing,

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270. See *supra* note 248 and accompanying text.

271. See *What We Do*, PAVE <https://web.archive.org/web/20130328170616/http://www.pave.com/>, archived at <http://perma.cc/9JJQ-5V8P> (last visited Feb. 7, 2015).

272. *Id.*

location of income inclusion, recovery of investment (i.e., tax basis), and deductibility of costs (e.g., interest).

It is not inconceivable that the IRS could treat Pave as a partnership for tax purposes. The Internal Revenue Code has defined a partnership to include a “syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on.”<sup>273</sup> Treasury regulations provide that “[a] joint venture or other contractual arrangement may create a separate entity [i.e., a partnership] for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom.”<sup>274</sup> In addition, cases and IRS rulings contain precedent for recharacterizing lending and other economic relationships as partnerships.<sup>275</sup> It is well known that debt-equity analysis applies in the partnership tax context to distinguish partnership equity from debtor-creditor relationships.<sup>276</sup> Even arrangements that have some features of debt (such as a very certain return) have been treated as equity for tax purposes.<sup>277</sup>

If Pave were taxed according to partnership principles, the following key results might follow: First, the Pave “partnership” would be required to keep book and tax capital accounts, track basis adjustments at the partnership level, and file a partnership-level information return.<sup>278</sup> Second, even though taxable income would be computed at the partnership level,<sup>279</sup> each partner would have to include for tax purposes her distributive share of partnership income in her gross income, regardless of whether she has actually received any

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273. I.R.C. §§761(a), 7701(a)(2) (2012).

274. Treas. Reg. § 301.7701-1(a)(2) (2014); *see also* Comm’r v. Culbertson, 337 U.S. 733, 742 (1949) (holding that a partnership exists when two or more “parties in good faith and acting with a business purpose intend[ ] to join together in the present conduct of the enterprise”).

275. Rev. Rul. 90-27, 1990-1 C.B. 50; Rev. Rul. 78-142, 1978-1 C.B. 111; *Hartman v. Comm’r*, 17 T.C.M. (CCH) 1020 (1958).

276. WILLIAM S. MCKEE ET AL., FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS, § 3.05[3] (4th ed. 2015) (“[T]he confusing morass of debt-equity cases that exist in the corporate context must be parsed in order to ascertain whether a particular relationship creates a partnership or merely a debtor-creditor relationship.”); I.R.S. Notice 94-47, 1994-1 C.B. 357; *see also* TIFD III-E, Inc. v. United States (*Castle Harbour*), 459 F.3d 220, 239–40 (2d Cir. 2006) (detailing factors to analyze “in determining whether an interest is “more akin to debt or equity”).

277. MCKEE § 3.05[3] (noting that “Congress and the Treasury have been willing to accept as equity many instruments that have nearly all of the enumerated qualities of debt” and that “while labeling may seem merely semantic, the words used have legal rights and obligations that attach to them and may ensure the result they represent”).

278. I.R.C. §§ 701, 703(a).

279. Given that Pave anticipates that Talent will file an individual Form 1040 providing the basis for the income sharing, it is unclear how the tax system’s requirement that a partnership return be filed instead would impact the implementation of Pave’s ISA.

partnership distributions.<sup>280</sup> While the distributive share is typically determined by the partnership agreement, where there is no agreement, it will be determined in accordance with the partner's interest in the partnership.<sup>281</sup> Third, partnership characterization would require tracking of each partner's basis in the partnership ("outside basis"). Generally speaking, outside basis is increased by a partner's distributive share of taxable income and decreased by any distributions to the partner and her distributive share of partnership losses.<sup>282</sup> Partnership treatment suggests that investors would not be permitted full recovery of their entire basis before having an income inclusion.<sup>283</sup>

The treatment outlined above differs from that which would result if Pave were, for example, treated as a debt or the sale of an income stream. It also differs from the tax treatment described in the Rubio-Petri Bill.<sup>284</sup> Key differences include (1) whether the funding recipient would include all income earned on her individual Form 1040, (2) whether she would receive an interest deduction on that Form 1040, and (3) how investors would be taxed on income received from their investment.<sup>285</sup>

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280. I.R.C. § 702(c).

281. I.R.C. § 704(a), (b). The distributive share will be computed in accordance with the partner's interest in the partnership if the partnership's allocations lack substantial economic effect. I.R.C. § 704(b). In computing partnership taxable income, certain deductions would be taken into account at the partner level on their separate tax returns and certain items would have to be separately stated. I.R.C. §§ 702(a)(1)–(7), 703(a). Also, a partner's capital account would be reduced for any actual distribution made to the partner and increased by the partner's distributive share of partnership income. I.R.C. § 705. *See generally*, WILLIAM LYONS & JAMES R. REPETTI, PARTNERSHIP INCOME TAXATION 44–60 (5th ed. 2011).

Treating Talent's income as belonging to the partnership is not prohibited by assignment of income principles. *See, e.g.*, *Schneer v. Comm'r*, 97 T.C. 643, 663 (1991) (right to pool partnership earnings overrode assignment of income principles). Courts have even held that salaries earned by an individual partner can be attributable to the partnership if germane to the partnership's business. *See, e.g.*, BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS § 75.2 (3d ed. 2015) (citing *Bufalino v. Comm'r*, 35 T.C.M (CCH) 494 (1976) (payments made to a partnership for services by one partner are includable in the income of the partnership rather than the partner); *Rev. Rul. 80-338*, 1980-2 C.B. 30 (executor fees for partner's services taxable to partnership, because partnership performed similar services)).

282. I.R.C. §§ 705, 722, 733.

283. *See, e.g.*, I.R.C. §§ 702(a), 704(a) (requiring a partner to include her distributive share of partnership income regardless of whether such income is actually distributed to her).

284. H.R. 4436, 113th Cong. §§ 201, 301 (2014).

285. For example, if Pave were treated like debt, Backers might include interest and determine income under something like the contingent bond method.

## 2. Securities Law

The two central issues in securities law are whether an instrument or arrangement is a security (and thereby subject to antifraud provisions under the 1933 Act and 1934 Act), and if so, whether offers to sell the security must be registered with the SEC under the 1933 Act.<sup>286</sup>

The 1933 Act defines the term “security” in part as “any note, stock, treasury stock, . . . bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit sharing agreements, . . . [or] investment contract.”<sup>287</sup> Given that stock is an enumerated instrument in the securities law definition of a security,<sup>288</sup> there is a strong presumption that stock is a security, and certainly corporate stock would be so treated.<sup>289</sup> “Notes” are also an enumerated instrument that constitutes a security,<sup>290</sup> with a corresponding presumption.<sup>291</sup> However, securities case law has developed a test to determine when a given note should in fact be treated as a security and when it should not. Under the Supreme Court’s “family resemblance” test, notes are presumed to be securities unless they share family resemblance (using a four-factor test) to a judicially crafted list of transactions that are *not* considered securities.<sup>292</sup>

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286. See, e.g., EXEC. OFFICE OF THE PRESIDENT, STATEMENT OF ADMINISTRATION POLICY: H.R. 2930—ENTREPRENEUR ACCESS TO CAPITAL ACT (Nov. 2, 2011), *available at* [http://www.whitehouse.gov/sites/default/files/omb/legislative/sap/112/saphr2930r\\_20111102.pdf](http://www.whitehouse.gov/sites/default/files/omb/legislative/sap/112/saphr2930r_20111102.pdf), *archived at* <http://perma.cc/X4KJ-URLB> (“The President[] . . . called for cutting away the red tape that prevents many rapidly growing startup companies from raising needed capital, [and supported a securities regulation exemption from registration] for ‘crowdfunding.’”).

287. Securities Act of 1933 §2(1), 15 U.S.C. § 77b(a)(1) (2012).

288. *Id.*

289. *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 686 (1985).

290. 15 U.S.C. § 77b(a)(1).

291. See, e.g., *Reves v. Ernst & Young*, 494 U.S. 56, 64–66 (1990) (interpreting the language of the Securities Acts as creating the rebuttable presumption that every note is a security).

292. *Id.* at 67; see 15 U.S.C. § 77(a)(1). In its “family resemblance test,” the Court, citing *Exchange National Bank of Chicago v. Touche Ross & Co.*, 544 F.2d 1126, 1137 (2d Cir. 1976) and *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 939 (2d Cir. 1984) outlined four types of notes that would not be securities: (1) “the note delivered in consumer financing, the note secured by a mortgage on a home,” (2) the “short-term note secured by a lien on a small business or some of its assets,” (3) “the note evidencing a ‘character’ loan to a bank customer,” and (4) the “short-term notes secured by an assignment of accounts receivable, or a note which simply formalizes an open-account debt incurred in the ordinary course of business (particularly if, as in the case of the customer of a broker, it is collateralized).” The Court further identified four basic themes that explained why certain notes should not be considered securities: (1) motivation (e.g., issuer seeking general funds v. funding for a small asset); (2) plan of distribution for the instrument; (3) reasonable expectations of the investing public; and (4) existence of other regulatory oversight that reduces the need for securities regulation. *Reves*, 494 U.S. at 65–67.

Finally, partnership interests, though not explicitly included on the enumerated list of instruments treated as a security,<sup>293</sup> may be a security if they constitute an “investment contract” under the statute.<sup>294</sup> This determination is made on the basis of the Supreme Court’s *Howey* test.<sup>295</sup> The Court in *Howey* provided that the term “investment contract” under the Securities Act of 1933 covered a “contract, transaction or scheme whereby a person”: (1) “invests his money,” (2) “in a common enterprise,” and (3) “is led to expect a profit,” and (4) the expected profits are “solely<sup>296</sup> from the efforts of the promoter or a third party.”<sup>297</sup> The fourth prong of the *Howey* test (regarding expecting profits solely from the efforts of others) is likely to be of greatest significance in analyzing the Pave transaction’s treatment under securities regulations. In assessing whether a joint venture or partnership has created a security interest (i.e., whether it constitutes an “investment contract”), courts carefully examine the role played by different parties in generating the profits and whether that role has been vested in a particular individual or group.<sup>298</sup>

Thus, the determination of whether a given contract or arrangement constitutes a security under the 1933 Act and the 1934 Act depends on the type of instrument that has been issued (e.g., note, stock, partnership interest, or other). Assuming that an interest constitutes a security, it will be subject to the antifraud provisions of the 1933 Act and the 1934 Act. However, not all securities issuances are subject to the registration requirements of the 1933 Act. Although a complete analysis of the securities registration rules is beyond the scope of this Article, it is instructive to briefly consider one of the categories of transactions exempt from 1933 Act registration: “transactions by an issuer not involving any public offering.”<sup>299</sup>

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293. 15 U.S.C. § 77b(a)(1).

294. *Id.*

295. SEC v. W.J. Howey Co., 328 U.S. 293, 298–99 (1946) (detailing the definition of “investment contracts”).

296. Subsequent courts have softened the *Howey* framing of the profit expectation to provide that the prong is met if the profits are to be derived “primarily” or “substantially” from the efforts of others. See, e.g., United Housing Found., Inc. v. Forman, 421 U.S. 837, 855 (1975) (applying a substantiality standard); SEC v. Glenn W. Turner Enters., 474 F.2d 476, 482 (9th Cir. 1973) (“[T]he word ‘solely’ [in *Howey*] should not be read as a strict or literal limitation . . . , but rather must be construed realistically, so as to include . . . schemes which involve in substance, if not in form, securities.”).

297. *Howey*, 328 U.S. at 298–99.

298. See, e.g., Williamson v. Tucker, 645 F.2d 404, 419–26 (5th Cir. 1981) (reviewing the analysis for determining whether joint venture and partnership arrangements constitute “investment contracts” under the 1933 Act).

299. 15 U.S.C. § 77d(a)(2) (2012).

Over the years, courts and the SEC have developed a set of criteria used to determine whether there has been a “public offering.” The Supreme Court in *SEC v. Ralston Purina Co.*<sup>300</sup> focused on the nature of the offerees in evaluating the nature of the offering. Specifically, the Court concluded that to secure the exemption: (1) all offerees needed access to the type of information that would otherwise be included in a 1933 Act registration statement, and (2) the offerees must be sufficiently sophisticated to seek and understand available information.<sup>301</sup> The SEC has added an additional expectation that “public advertising is inconsistent with a claim of private offering,”<sup>302</sup> and courts have included other factors to be assessed.<sup>303</sup>

In evaluating the Pave transaction under securities law, the threshold inquiry would be whether Pave’s arrangement constitutes a security under the 1933 Act. Given our determination that Pave may look most like a partnership, we would apply the investment contract/*Howey* analysis described above. Recall that the fourth *Howey* prong considers whether profits were expected to be derived by the investor solely from the efforts of others.<sup>304</sup> Thus, the degree to which Pave investors (Backers) exercise managerial control or authority over the “enterprise” becomes critical in the securities law treatment of the arrangement. The more control exercised over the funding recipient’s choices, the less likely that the ISA is a security that requires registration.<sup>305</sup> Although Pave emphasizes mentoring, real managerial control by investors is arguably absent, which increases the likelihood that Pave’s arrangement would be subject to regulation as a security.

Relatedly, assuming the Pave transaction constitutes a security subject to the 1933 Act and the 1934 Act (and correspondingly their

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300. 346 U.S. 119 (1953); *see also* Gilligan, Will & Co. v. SEC, 267 F.2d 461, 464–65 (2d Cir. 1959) (the nature, not number, of offerees determines whether there was a public offering).

301. *Ralston*, 346 U.S. at 126–27.

302. Non-Public Offering Exemption, Exchange Act Release No. 33-4552, 1 Fed. Sec. L. Rep. (CCH) ¶ 2781 (Nov. 6, 1962), 1962 WL 69540.

303. Among the factors considered by some courts include the number of offerees and the size of the offering. *E.g.*, Mark v. FSC Sec. Corp., 870 F.2d 331, 333 (6th Cir. 1989); Cook v. Avien Inc., 573 F.2d 685, 691 (1st Cir. 1978) (citing Doran v. Petroleum Mgmt. Corp., 545 F.2d 893, 899–900 (5th Cir. 1977) (considering number of purchasers)); Hill York Corp. v. Am. Int’l Franchises, Inc., 448 F.2d 680, 687 (5th Cir. 1971); Barnett v. Triangle Mining Corp., Fed. Sec. L. Rep. (CCH) ¶ 95,439 (S.D.N.Y. Feb. 2, 1976).

304. *See supra* note 296 and accompanying text.

305. *See* Hurt, *supra* note 125, at n.95 (observing that a general partnership interest, in contrast to a limited partnership interest, is presumptively not an investment contract). But where the facts demonstrate that the general partners lack management knowledge and control, even a general partnership interest can be a security. *Id.* (citing SEC v. Merch. Capital, LLC, 483 F.3d 747 (11th Cir. 2007)). *See also* Williamson v. Tucker, 645 F.2d 404, 422–23 (5th Cir. 1981) (general partnership interest is a security if there is no meaningful control).

fraud liability provisions), there remains the additional question of whether the Pave transaction would be subject to registration requirements. Again, a factual inquiry would demand scrutiny of the nature of the offerees and the circumstances in which the offering was made, using the analysis developed by *Ralston Purina Co.* and subsequent cases.

Fundamentally, however, what is more significant for purposes of the inquiry undertaken in this Article is not the ultimate treatment of Pave by the 1933 Act and the 1934 Act but rather the mode of analysis for determining their treatment. Depending on how the Pave transaction was labeled, it would be subject to a different analysis under the securities law. For example, stock would have a strong presumption of status as a security;<sup>306</sup> a note would be analyzed using the family resemblance test;<sup>307</sup> and a partnership would be evaluated using the *Howey* test for investment contracts.<sup>308</sup> The preliminary step of regulation by analogy assigns the ISA a “label,” and that label determines which analytical path will apply under the securities laws. Beginning the entire process with attention to analogy helps ensure that, for example, ISAs that look more similar to debt are subject to a securities regulation regime comparable to that accorded to traditional loans (such as student loans, consumer loans, or mortgages).

### 3. Other Consequences of Partnership Characterization

Tax and securities law are just two regulatory fields that are impacted by a conclusion that Pave looks most like a partnership. Partnership characterization would also hold consequences in other areas of law. For example, an array of bankruptcy-related issues turn on the question of whether Pave is considered a partnership or something else (such as debt).<sup>309</sup> A finding of partnership may render investors liable in tort for acts of the funding recipient.<sup>310</sup> It may also

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306. *See, e.g.,* *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 688 (1985) (“[I]t would improperly narrow Congress’ broad definition of ‘security’ to hold that the traditional stock at issue here falls outside the Acts’ coverage.”).

307. *Reves v. Ernst & Young*, 494 U.S. 56, 63–64 (1990).

308. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298–99 (1946).

309. For example, if funding providers are creditors, they would have a claim against funding recipients in the event of bankruptcy. In contrast, if Pave is a partnership, then each partner might be considered liable for certain debts of the partnership owed to other creditors. Additionally, if one of the “partners” files for bankruptcy, there may also be consequences for continuity of the partnership.

310. Liability can attach both to the partnership and individual partners. The Uniform Partnership Act provides: “A partnership is liable for loss or injury caused to a person, or for a penalty incurred, as a result of a wrongful act or omission, or other actionable conduct, of a partner acting in the ordinary course of business of the partnership or with authority of the partnership.”

impact the application of state usury laws, as well as the jurisdiction of the Consumer Financial Protection Bureau.

#### 4. Observations on Regulation

A few caveats are in order. First, as noted, regulation by analogy is likely to be most compelling where the closest analogue is also a viable substitute. We believe that this will be the case in most situations. For example, individuals looking for funding for a new technology business could pursue funding via Pave, or could alternatively seek investments from friends, family, or the public. If the legal system draws regulatory distinctions between transactions that function as close substitutes, this may distort the choice of transactional form in a way that might be inefficient.<sup>311</sup> However, where the closest analogue is not a viable substitute, or where some other funding approach is so clearly prevalent as to make the closest analogue irrelevant, then other considerations may suggest adoption of a different regulatory treatment.

Second, we make no claim that the most analogous regulatory regime will be perfect. Indeed, analogizing to partnerships may subject the parties to the complicated rules applicable to partnerships.<sup>312</sup> Complications may also arise if regulatory fields disagree regarding the characterization of an arrangement. Our point is that such challenges are a feature of our current regulatory reality. For example, smaller partnerships, such as the vegetable-stand operators in our earlier example, are already subject to complicated partnership rules. Any discussion of whether reforms are necessary or whether a safe harbor should be enacted should take place as part of a broader conversation.

Third, as previously noted, we are open to the possibility of creating a narrowly crafted safe harbor that provides regulatory

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UNIF. P'SHIP ACT § 305(a) (1997). Similarly, the UPA states: "Except as otherwise provided . . . , all partners are liable jointly and severally for all obligations of the partnership unless otherwise agreed by the claimant or provided by law." *Id.* § 306(a).

311. Again, we do not argue that current regulatory regimes are efficient or optimal. We merely contend that additional inefficiency-generating lines should not be drawn without due consideration of their location.

312. For example, under United States tax law, a partnership is required to file an annual information return reporting its income, gains, losses, deductions, and credits from partnership operations. I.R.C. § 6031. However, the partnership itself does not pay income tax. *Id.* § 701. Instead, items of partnership income, gains, losses, deductions, or credits are passed through to the partners, who must take separate account of their respective distributive shares of such partnership items on their respective tax returns. *Id.* §§ 702, 704. There are also detailed rules governing partner and partnership basis computations, contributions to partnerships, partnership distributions, transfers of partnership interests, and other matters. *Id.* §§ 705, 721–743.



certainty in specific situations.<sup>313</sup> For example, tax law could mandate a particular treatment for certain person-to-person ISAs of a short duration that require repayment of a limited percentage of future income and that are for certain specified purposes (e.g., education).<sup>314</sup> The existence of such a safe harbor would mean that certainty of tax (or other regulatory) treatment could be achieved without resort to analogy in those cases falling within the safe harbor. However, such safe harbors ought to be narrowly crafted in order to minimize distortions and inequities.

Finally, we do not claim that there will never come a time when a new regulatory regime for various ISAs would be advisable. Our contention is that because ISAs are new and may develop in uncertain directions, a wait-and-see approach that analyzes and classifies them by analogy to existing legal categories is preferable to creating a new legal category at the outset. Even if and when such a new regime may be warranted, however, it is unlikely that such new regime would be uniformly appropriate for all ISAs. Any new regulatory category would need to be narrowly tailored and carefully considered.

### *C. Critiquing the “Investing in Student Success Act of 2014”*

Legislation introduced by Senator Rubio and then-Representative Petri in the 113th Congress sought to clarify the legal treatment of ISAs. The proposed legislation was ultimately not enacted but nonetheless is an example of the kind of approach against which this Article cautions.<sup>315</sup> Instead of recognizing the heterogeneity of ISAs, the proposed legislation accords a unified regulatory treatment to a wide array of possible arrangements without differentiating between them based on their underlying economics. The legislation also does not consider how its proposed legal treatment would mesh with current legal categories for regulating similar existing transactions, and what inequities and distortions might be created by the interaction of these regimes.

#### 1. Legal Status

The proposed Rubio-Petri Bill authorized individuals to enter into “income share agreements,” defined to include agreements entered into for “postsecondary education, workforce development, or other

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313. *See supra* note 162.

314. *Id.* As noted, safe harbors are a design feature of many regulatory fields. *See supra* notes 18, 159 and accompanying text.

315. Investing in Student Success Act, H.R. 4436, 113th Cong. pmb. (2014).

purposes.”<sup>316</sup> The bill covered agreements meeting the following requirements: (1) the first \$10,000 of income (as defined under the contract) is exempt from the repayment obligation; (2) the maximum contract duration does not exceed thirty years (not including extensions for years in which the individual’s income is below the \$10,000 exemption amount); (3) the agreement specifies ways in which the contractual obligation may be extinguished before the end of the payment period; (4) the aggregate amount pledged under all ISAs entered into by the individual does not exceed fifteen percent of the individual’s future income; and (5) the agreement contains certain required disclosures.<sup>317</sup> The legislation also contained a noninterference provision providing that “[a]n income share agreement shall not be construed to give the contract holder any rights over an individual’s actions—it simply represents an obligation by the individual [to] pay the specific percentage of future income.”<sup>318</sup>

The first problem is that the class of transactions authorized is potentially both too broad and too narrow. It is too broad because it might encompass transactions with troubling servitude-like characteristics as well as more benign arrangements. Specifically, a transaction that authorizes fifteen percent income sharing over thirty years (not including extensions) may last almost the entire duration of a person’s working life and may encumber a significant portion of income during that time. The proposed legislation also allowed the parties to define “income” under the contract, without any restrictions on breadth.<sup>319</sup> Finally, despite the noninterference provision, the bill did not account for situations in which funding providers exert soft controls over the career and work choices of recipients. As discussed in Part IV.B, these are factors that could render an ISA too close to a servitude-like arrangement to be normatively or legally permissible.<sup>320</sup> Yet, the legislation did not adequately distinguish acceptable from unacceptable transactions.

On the other hand, the legislation was too narrow because it is unclear what it would do to a transaction like Fantex. The proposed legislation might not have authorized Fantex because Fantex (1) does not have a \$10,000 exemption and (2) has a clawback clause should the football player quit within two years.<sup>321</sup> Yet one could argue that of all

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316. *Id.* § 102(a).

317. *Id.* § 102(b)–(c).

318. *Id.* § 102(d).

319. *Id.* § 102(b)(2).

320. *See supra* Part IV.B.

321. *See* Fantex, Inc., *supra* note 1, at 25.

the ISAs, the Fantex athletes are most likely to hold negotiating power and that Fantex looks more like insurance for the athlete than a problematic equity- or ownership-like arrangement. To the extent that the proposed legislation might not have covered Fantex (because it failed to recognize its risk-management qualities), it might be underinclusive.

The simultaneous over- and underinclusiveness of the proposed bill highlights our concerns regarding overarching legislative solutions at the present time. New regulatory regimes that are crafted hastily, without assessing the individual economics of each transaction, may inadvertently incentivize the wrong kinds of ISAs while suppressing more benign variants. This may create distortions in the ISA sector, particularly if done without considering how the industry might subsequently develop. It is also not clear that simply crafting a narrower bill will solve these problems because even a narrower bill may be unintentionally over- or underinclusive and distortive.

## 2. “Not Debt” Characterization

A second problem is the bill’s assertion that ISAs are not debt and should not be treated like debt. The bill required covered ISAs to include the following disclosure: “[T]he agreement is not a debt instrument, and . . . the amount the individual will be required to pay under the agreement (A) may be more or less than the amount provided to the individual; and (B) will vary in proportion to the individual’s future income.”<sup>322</sup> The bill also provided that ISAs will not be subject to state usury laws.<sup>323</sup>

The bill’s insistence that ISAs are not debt did not appreciate that different ISAs may have different economics and that *some* present and future variants may look enough like contingent debt that they should be regulated as such. For example, some ISAs are subject to modeling to achieve a specific rate of return (e.g., seven percent in the case of Pave).<sup>324</sup> If the economics of the transaction as structured make it extremely likely that the investor will earn a certain rate of return despite the appearance of risk or contingency, it may well make sense

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322. H.R. 4436, 113th Cong. § 102(c)(1) (2014).

323. *Id.* § 104.

324. See, e.g., Richie Bernardo, *Usury Laws by State, Interest Rate Caps, the Bible & More*, CARDHUB, <http://www.cardhub.com/edu/usury-laws/#state>, archived at <http://perma.cc/7KTM-PQS2> (last visited Jan. 18, 2015) (listing usury rates by state, including North Dakota’s 5.55 percent limit, Michigan’s 7 percent limit, Iowa’s 4.75 percent limit, and Pennsylvania’s 6 percent limit).

for state usury laws to apply, especially since the rate of return on some ISAs may exceed the maximum interest rate under state usury laws.<sup>325</sup>

Failure to consider the ways in which ISAs may resemble debt may enable traditional lenders to use loan-like versions of ISAs to circumvent state usury laws and other debt rules. This is symptomatic of a more general concern: designing new regulatory regimes without examining ISAs on a case-by-case basis or considering how a new regime may interact with existing ones to create costs and distortions is a risky approach. Given the newness of ISAs, regulation should be undertaken on a more nuanced basis.

### 3. Taxation

The proposed bill's tax treatment of ISAs was somewhat inconsistent with its assertion that ISAs are not debt. Under the bill, the amount initially received by the funding recipient is not includible in the recipient's gross income.<sup>326</sup> This is consistent with the tax treatment of traditional borrowing.<sup>327</sup> However, the bill did not address the situation in which the funding recipient ultimately repays the funding provider less than the funds received. In the case of debt, there would likely be cancellation of indebtedness income to the funding recipient.<sup>328</sup> The bill also provided that ISAs are not eligible for the student loan interest deduction.<sup>329</sup>

With respect to the funding provider, the bill allowed full basis recovery before an income inclusion.<sup>330</sup> Thus, if a funding provider invests \$10,000, and receives \$2,000 a year for ten years under an ISA, she does not have a gross income inclusion until the sixth year. Such upfront basis recovery is inconsistent with the tax treatment of traditional lenders, who may recover basis in a manner more consistent with accrual accounting. Oddly, though, the bill labeled the funding provider's income from the ISA as "interest," despite the fact that the

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325. See *State Usury Laws—Maximum Legal Interest Rates*, LENDINGKARMA, <http://www.lendingkarma.com/content/state-usury-laws-legal-interest-rates/>, archived at <http://perma.cc/7S7J-HUJQ> (last visited Jan. 18, 2015) (detailing each state's maximum interest rates).

326. H.R. 4436 § 201(a).

327. See *Comm'r v. Tufts*, 461 U.S. 300, 307 (1983) ("Because of the obligation [to repay the loan at a future date], the loan proceeds do not qualify as income to the taxpayer.").

328. See I.R.C. § 108 (2012) (defining limited exceptions to the rule that discharge of debt is income in circumstances involving bankruptcy, insolvency, real property, and farms). Thus, if a funding recipient ultimately repays only \$8,000 over the life of the ISA, should she have to include \$2,000 in gross income and, if so, when?

329. H.R. 4436 § 301(a); see also I.R.C. § 221(a) (outlining the student loan interest deduction).

330. H.R. 4436 § 201(b)(1).

agreement is expressly required to state that the ISA is not debt in order to be covered by the bill.<sup>331</sup>

This proposed tax treatment is problematic because it creates jagged intersections with the tax treatment of similar financial instruments (most obviously debt, but others as well) without thinking them through. The treatment accorded ISAs is sometimes more favorable than that given other transactions (e.g., upfront basis recovery) but sometimes less so (e.g., denial of student loan interest deduction). These differences may create tax-induced distortions in the choice between two economically similar instruments, not to mention potential tax inequities. Again, we are not saying that lines should never be drawn and special regimes never created. Our point is that such lines should be created with caution.<sup>332</sup>

#### 4. Bankruptcy Discharge

The proposed legislation made ISAs nondischargeable in bankruptcy, although it was confusing on this point. Specifically, the bill would have amended I.R.C. § 221(d)'s definition of "qualified education loans" to include "income share agreements." Therefore, by cross-reference, it made covered ISAs nondischargeable, because "qualified education loans" are excepted from bankruptcy discharge.<sup>333</sup> The bill also required a disclosure that "the obligations of the individual under the agreement are not dischargeable under bankruptcy law."<sup>334</sup> Such nondischargeability tracks existing bankruptcy treatment of education debts but differs from the treatment of many other debts.

Confusion arises because the bill defined "income share agreements" to include agreements "for postsecondary education, workforce development, or other purposes."<sup>335</sup> Thus, the bill made *all* ISAs nondischargeable, not just those entered into for education funding purposes. This treatment is overinclusive with respect to some ISAs and may distort the choice between ISAs and traditional debt.<sup>336</sup> Here, again, appreciating the heterogeneity of possible ISA arrangements can help reduce regulatory discontinuities.

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331. *See id.* §§ 102(c)(1), 201(b)(2).

332. *See, e.g.,* Weisbach, *supra* note 16, at 1627–28 (cautioning that distinctions in tax law "be based on the efficiency of competing rules rather than on doctrinal concerns or traditional tax policy").

333. 11 U.S.C. § 523(a)(8)(B).

334. H.R. 4436 § 102(c)(2).

335. *Id.* § 102(a) (emphasis added).

336. But to the extent recipients seek ISA funding to pay off nondischargeable student loans before seeking a bankruptcy discharge, it might be appropriate to make those ISAs nondischargeable as an antiabuse measure.

## 5. Investment Company Act Treatment

The proposed legislation would also have amended the Investment Company Act of 1940.<sup>337</sup> The Investment Company Act (“ ’40 Act”) seeks to protect investors who trust others with the management and investment of their savings through a vehicle that typically uses the invested funds to hold cash, securities, and/or futures and commodities. Mutual funds, for example, are classic investment companies. From an investor perspective, the arrangement offers investment expertise and diversification. But the arrangement also poses the risk of abuse by the managers, particularly given the liquid nature of the assets held (as compared to an operating business).<sup>338</sup> Thus, the Investment Company Act requires covered companies to register (unregistered investment companies are barred from interstate commerce under Section 7 of the Investment Company Act) and imposes various restrictions on their operation in order to curb the risk of abuse. Among the various restrictions and oversight provisions, Section 15 of the Investment Company Act regulates the relationship between an investment company and its underwriters and investment advisors. Absent such regulation, this relationship could be prone to abuse where the “advisor” is also the organizer of the investment company.

The Rubio-Petri Bill sought to exclude from the definition of “investment company” persons in the business of arranging ISAs.<sup>339</sup> If such persons are excluded, the investor protections of the Investment Company Act would not apply to investors in ISAs. The bill would have achieved this by expanding the current exemption in the Investment Company Act from the definition of “investment company.” The exemption currently applies to persons engaged in banking, lending, and related activities (Section 3(c) of the ’40 Act), and the bill would have expanded it to include ISAs. The bill would also have expanded the current exemption for persons who do not issue certain securities or certificates and are engaged in specified lending type activities by including ISAs in those specified activities.<sup>340</sup> Thus, the proposed bill effectively exempted businesses offering ISAs from regulation under the ’40 Act.

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337. 15 U.S.C. § 80a-3(c).

338. *See, e.g.*, S. REP. NO. 76-1775, at 6 (1940) (“[I]ndividuals who lack integrity will continue to be attracted by the opportunities for personal profit available in the control of the liquid assets of investment companies . . .”).

339. H.R. 4436 § 501(1).

340. *Id.* § 501(2).

Like other aspects of the bill, the investment company provisions failed to appreciate the variety of possible ISA structures and how their legal treatment may interact with that of similar financial arrangements. While some ISAs are peer-to-peer, others might, in fact, operate similarly to investment companies, as envisioned by the '40 Act, and serve as a centralized repository of cash for passive investment and diversification by managers. For example, Lumni enables investors to invest in “funds” managed by Lumni, where the *fund* enters into income sharing arrangements with students.<sup>341</sup> Lumni offers investors a choice of different funds, including for-profit and nonprofit variants.<sup>342</sup> It is not obvious why such funds should be per se exempt from the “investment company” definition, and the investors excluded from Investment Company Act protections, just because the funds hold and offer ISAs.<sup>343</sup> This regulatory decision creates inequities based on fund portfolios and is likely to generate gaps, distortions, and costs. It might encourage the development of a market for investment funds holding ISAs that replicate the business of investment companies but escape '40 Act requirements. In contrast, an approach based on regulation by analogy would ask whether a given ISA closely mirrors structures traditionally covered by the '40 Act and would recommend consistent treatment absent a compelling reason for departure.

## 6. Summary Observations

Failure to consider the particular economics of different ISAs and to examine how their regulatory treatment would interact with that of similar financial arrangements creates inequities and behavioral distortions at the regulatory intersections. Again, we do not argue that new regulatory categories should never be created. We simply point out that imposition of a new regulatory regime without fully understanding the content and development of the regulated industry is likely to draw lines in an inefficient and inequitable manner.

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341. See *About Lumni*, *supra* note 7 (describing “Lumni’s fund management model”).

342. *Id.*

343. Such funds might qualify for another exemption, such as a (3)(c)(1) or (3)(c)(7) exemption. 15 U.S.C. §§ 80a-3(c)(1), (7) (2012). The point is that the requirements for such exemptions would have to be met independently. There would not be a blanket carve out. Furthermore, even if we decided that Lumni’s education focus justified its exclusion from the Act, the actual scope of the Rubio-Petri proposal is much broader.

## VI. CONCLUSION

The new ISAs raise a number of important public policy and regulatory issues that the legal system is only now beginning to contemplate. Given the growth and proliferation of ISAs, however, these regulatory issues cannot be ignored. This Article has proposed an analytical approach to evaluating ISAs and designing their regulation. It has argued that case-by-case regulation by analogy—that is, comparing and analogizing each new transaction to existing financial arrangements and regulating it akin to its closest analogue—is most likely to yield efficient rules that are not over- or underinclusive. Regulation by analogy can help avoid the drawing of unfair and distortionary lines between economically similar transactions. By contrast, a hastily implemented, unified regulatory scheme that governs all ISAs runs the risk of being poorly tailored because the new agreements are not homogeneous. This Article has suggested a multifactor analysis that probes each transaction's true economics, regardless of its formal labels, in performing such regulation by analogy.

One might argue that regulation by analogy creates certain risks, including the risk of chilling the ISA market due to lack of regulatory certainty. The desire for regulatory certainty or predictability is a reasonable goal. However, as we have argued, regulatory certainty should not be conflated with substantive uniformity. It is possible to achieve a degree of regulatory certainty while nevertheless choosing to regulate by analogy. This could be accomplished, for example, through the use of advance rulings or prototype guidance, or through the judicious use of safe harbors. Moreover, substantive uniformity does not necessarily guarantee regulatory certainty in application.

We do not suggest that a unified framework will never be possible or desirable. There may well come a time when, given more information about these new transactions, it will be possible to craft a more unified regulatory approach for at least some ISAs. We argue, however, that now is not that time. The market for ISAs is relatively new and still developing. Future variants are likely to emerge. Given the lack of information and experience regarding these agreements, regulation by analogy is the better approach.

Finally, we in no way imply that current regulatory regimes are necessarily perfect or even adequate. Nor do we imply that familiar preexisting categories, such as debt, do not raise important public policy issues. In fact, there may be serious problems with our current regulatory approaches, and income share agreements may serve to



illuminate the public policy concerns raised by long-accepted arrangements, such as debt. Our point is merely that, to the extent that there are deficiencies in current regulatory schemes, this is a problem that should be taken up separately. In this sense, our regulation by analogy proposal may be characterized as a “second-best proposal” for an imperfect world.