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# The New Human Equity Transactions

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# California Law Review Circuit

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## The New “Human Equity” Transactions

Shu-Yi Oei\* & Diane M. Ring\*\*

### INTRODUCTION

The diverse U.S. financial landscape offers opportunities to invest in land, businesses, corporations, and intellectual property. But can we invest in other humans? Should we be permitted to own a stake in someone else’s human capital just as we own other assets? Over the past two years, new financing structures have emerged that enable investors to provide funding to individuals in exchange for a percentage of that individual’s future earnings over a specified time period. Some of these new structures connect investors to individuals seeking financing for education or business costs. Another targets high-profile athletes and allows investors to acquire a stake in the athlete’s future earnings in exchange for a current investment, which is paid to the athlete.

Although the details vary, each of these financing vehicles essentially permits funding providers to take a slice of the recipient’s future return on her human capital over a certain time period, securing the upside if earnings are high and bearing the downside risk if earnings are lower than anticipated. Put differently, they allow individuals to monetize indeterminate future earning streams in exchange for immediate funding. This represents a significant departure from traditional forms of debt financing. While these arrangements do have precursors in older arrangements or proposals, such as Bowie Bonds<sup>1</sup>

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1. See, e.g., *Bowie’s Latest Hit: Royalty-Tied Bonds*, N.Y. TIMES, Feb. 21, 1997, at B5 (describing asset-backed securities that allow investors to receive a cut of future revenue derived from

or human capital contracts,<sup>2</sup> the current social and financial environment, paired with the availability of technology that enables access to a large number of investors, magnifies their potential impact.

The fact that these new arrangements differ from traditional debt raises an important question: What kind of financing arrangement are they, and how should they be classified for a variety of legal and regulatory purposes? Both the popular press and the businesses promoting these new investment structures have loosely characterized them as a type of ownership interest in humans.<sup>3</sup> For example, one company describes its structure as an opportunity to “invest directly in the person, not their idea or business”<sup>4</sup> and encourages potential financiers to “[i]nvest in people – literally.”<sup>5</sup> Another urges: “Invest in Talent. [Our company] turns talent into an asset.”<sup>6</sup> Still another has been described in the media as providing a chance to “own a piece of an athlete.”<sup>7</sup> These descriptions, if accurate, raise clear ethical (not to mention constitutional)

David Bowie’s albums).

2. For an early discussion of human capital contracts, see Milton Friedman & Simon Kuznets, INCOME FROM INDEPENDENT PROFESSIONAL PRACTICE 90 n.20 (National Bureau of Economic Research 1954) (“[I]f 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.”). See also Miguel Palacios Lleras, INVESTING IN HUMAN CAPITAL (2004) (suggesting an equity-like human capital contracts approach to education financing).

3. See, e.g., 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> (noting that “[s]ome have criticized Upstart as indentured servitude or slavery” but disagreeing with that characterization); Matt Levine, *Football Player Derivatives are the Best Derivatives*, BLOOMBERGVIEW (Nov. 1, 2013), <http://www.bloombergvie.com/articles/2013-11-01/football-player-derivatives-are-the-best-derivatives> (“The squick factor is obvious -- you’re buying a person! indentured [sic] servitude! etc.”); Elliot Hannon, *Is This Indentured Servitude or the New Venture Capital?*, SLATE (Oct. 29, 2013), [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) (noting that Upstart “feels a lot like indentured servitude”); James Surowiecki, *The New Futurism*, THE NEW YORKER, (November 4, 2013), [http://web.archive.org/web/20131031185150/http://www.newyorker.com/talk/financial/2013/11/04/131104ta\\_talk\\_surowiecki](http://web.archive.org/web/20131031185150/http://www.newyorker.com/talk/financial/2013/11/04/131104ta_talk_surowiecki) (noting that the Upstart “concept seems uncomfortably close to indentured servitude”); 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/> (“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.”).

4. See UPSTART (Apr. 19, 2014), <https://www.upstart.com/>; see also Archived Upstart Webpage, INTERNET ARCHIVE WAY BACK MACH. (Apr. 19, 2014), <http://web.archive.org/web/20140419222848/https://www.upstart.com/>. Another Upstart ad characterizes the financing structure as one in which “people invest in people.” See Upstart Ad on Boston.Com, BOSTON.COM (Apr. 22, 2014) (copy on file with the authors).

5. See Archived Upstart Webpage, *supra* note 4.

6. See PAVE, <http://www.pave.com> (last visited Apr. 30, 2014).

7. Darren Rovell, *Fantex to Offer Arian Foster Stock*, ESPN NFL (Oct. 18, 2013), [http://espn.go.com/nfl/story/\\_/id/9838351/fantex-brokerage-services-offer-stock-arian-foster-houston-texans](http://espn.go.com/nfl/story/_/id/9838351/fantex-brokerage-services-offer-stock-arian-foster-houston-texans); see also Mark DeBambre, *Own a Piece of an NFL Star*, N.Y. POST, BUSINESS (Oct. 17, 2013), <http://nypost.com/2013/10/17/want-to-own-a-piece-of-an-nfl-star-you-may-soon-be-able-to/>; Joy Chakravarty, *Want to ‘Own’ an NFL Star? Now You Can with Fantex Holdings*, SPORT 360° (Oct. 27, 2013), <http://v1.sport360.com/other-sports/want-own-nfl-star-now-you-can-fantex-holdings>.

questions.<sup>8</sup> The mere possibility that these transactions might be considered ownership suggests that they should be carefully monitored and potentially circumscribed and regulated. The need for vigilance is particularly acute because these transactions will undoubtedly evolve. Even if current iterations are not problematic, more aggressive future variations may be. Assuming that some of these arrangements are normatively permissible, present law lacks a framework for their regulation. In sum, these transactions pose serious questions for our legal system.

The initial task, then, is to determine the essential character of these transactions. Do they constitute unacceptable ownership of a human (or something closely analogous), as suggested by the popular press? This Essay argues that, to answer this question, we should draw upon existing jurisprudence that has developed to distinguish between debt and equity in the business context. Such debt-equity analysis is commonly employed in the tax and bankruptcy fields to distinguish creditors from firm owners in order to determine their proper legal and regulatory treatment. This Essay constitutes the first serious attempt in the legal literature at proposing a framework for analyzing whether these new transactions are normatively acceptable and, if so, what regulatory issues they may raise.<sup>9</sup>

Part I describes two examples of these new transactions—Upstart and Fantex. Upstart’s income share agreements enable investors to fund an individual’s start-up, project, or retirement of student loans. In return, investors receive a percentage of the individual’s income for a number of years. Fantex offers investors the opportunity to invest in stock that pays the investor a percentage of a professional athlete’s future sports-related income. Fantex pays the athlete an upfront payment (funded by the amounts invested) in exchange for which the athlete agrees to pay Fantex a percentage of his future income.

Part II argues that while these arrangements do not create direct ownership in humans as property, there is a risk that they may contractually approximate property ownership in problematic and undesirable ways. The challenge is determining whether a given transaction creates such human ownership via financial contract. Part II suggests that borrowing from tax law’s debt-equity analysis can help determine when a transaction creates human ownership and can also help evaluate the normative desirability of these deals. Part III offers a case study of one particular transaction to demonstrate how debt-equity analysis could be adapted to the new human financing transactions.<sup>10</sup> As the case study reveals, use of a modified debt-equity

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8. See U.S. CONST. amend. XIII (prohibiting slavery); see also Shu-Yi Oei & Diane M. Ring, *Human Equity and Contemporary Ownership: Conceptualizing and Taxing the New Human Equity Transactions* (forthcoming). For a discussion focusing on securities regulations issues regarding these transactions, see Jeff Schwartz, *The Corporatization of Personhood*, ILL. L. REV. (forthcoming 2015) (on file with authors).

9. We develop our analysis further in forthcoming work. See Oei & Ring, *supra* note 8.

10. In this Essay, we use the term “human financing transactions” to refer to Upstart, Fantex, Pave, and other similar emerging transactions.

framework can assist in determining whether a given transaction exhibits the type of de facto ownership likely to trigger public policy concerns.

## I.

### THE TRANSACTIONS

#### A. *Upstart*

In April 2012, Upstart introduced a funding model that allows potential investors to finance individuals seeking funding for business or education costs in exchange for a percentage of that individual's future earnings over a set time period.<sup>11</sup> Among the funding recipients profiled on the Upstart website were the owner of a technology start-up looking to expand his business,<sup>12</sup> a recent business school graduate looking for financing to start an e-commerce business,<sup>13</sup> and a 2012 law school graduate looking to retire his student debt.<sup>14</sup> In return for an upfront cash investment in the individual seeking funding (Recipient), the investors (Backers) earn a specified percentage of the Recipient's earnings for a set term, typically five years.<sup>15</sup> The underlying documentation is a funding agreement between Upstart (as middleman) and the Recipient.<sup>16</sup> In exchange for the funds, the Recipient agrees to pay the Backer

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11. See PAVE, *supra* note 6; Alison Griswold, *Upstart: Can Crowdfunding Your Education and Career Really Work?* FORBES (Aug. 10, 2012), <http://www.forbes.com/sites/alisongriswold/2012/08/10/upstart-can-crowdfunding-your-education-and-career-really-work/2/>; PAVE, *supra* note 6.

12. Paul Foley, UPSTART (January 24, 2014), <https://www.upstart.com/upstarts/paul-foley>, available at <https://web.archive.org/web/20140124072310/https://www.upstart.com/upstarts/paul-foley>. Profiles of the Upstart funding seekers are now available only upon signing in to the Upstart website.

13. Rachel Honeth Kim, UPSTART (March 31, 2014), <https://www.upstart.com/upstarts/rachel-honeth-kim>, available at <https://web.archive.org/web/20140331074530/https://www.upstart.com/upstarts/rachel-honeth-kim>.

14. Jeremy Glapion, UPSTART (March 31, 2014), <https://www.upstart.com/upstarts/jeremy-glapion>, available at <https://web.archive.org/web/20140331074133/https://www.upstart.com/upstarts/jeremy-glapion>.

15. See *Upstart Funding Agreement*, at cl. 5.a, [https://www.upstart.com/funding\\_terms](https://www.upstart.com/funding_terms) (last visited April 28, 2014) (on file with the authors) [hereinafter 2014 UPSTART AGREEMENT]. Previously, an option for a ten-year term was offered. See, e.g., *October 2013 Upstart Funding Agreement*, Upstart, at cl. 5.a, available at <https://web.archive.org/web/20121022201202/http://www.upstart.com/how-it-works/upstarts> (last visited Oct. 7, 2013) (on file with the authors) [hereinafter 2013 UPSTART AGREEMENT] (explicitly stating that the term of the agreement could be either five or ten years).

16. Upstart interposes a grantor trust (with Upstart as the trustor and a Delaware bank as trustee) between the Backers and the Recipient. See *Who is Upstart Network Trust?*, UPSTART, <http://investorhelp.upstart.com/questions/83773-Who-is-Upstart-Network-Trust> (last visited May 11, 2014). Upstart enters into the funding agreement with the Recipient and then transfers the funding agreement to the Trust (where it becomes a Trust asset). See *id.* The Trust issues securities to the Backers in exchange for funds that are used to pay the Recipient. See *Who is the Issuer of the Securities?*, UPSTART, <http://investorhelp.upstart.com/questions/83774-Who-is-the-issuer-of-the-securities> (last visited May 11, 2014). The Trust securities are secured by the funding agreements and the Backers only receive payment to the extent the Recipient pays the Trust. See *When Will the Trust Make Payments on a Loan Related Security*, UPSTART, <http://investorhelp.upstart.com/questions/83798-When-will-the-trust-make-payments-on-a-Loan-Related-Security> (last visited May 11, 2014);

(indirectly) the agreed percentage (the “income share”) of the Recipient’s total annual income as reported on her tax return<sup>17</sup> over the specified term.<sup>18</sup> Thus, the return to the Backers depends on the financial success of the Recipient.

The risk to the Backers is partially mitigated by the funding agreement’s deferral provision, which defers the annual income payments if the Recipient’s income for the year falls below a preestablished threshold. If this deferral provision is triggered, another year is added to the contract term. Recipients can obtain up to five such deferrals. After the fifth deferral, the Recipient is obligated to pay the income share for the remainder of the now-extended contract term.<sup>19</sup> The “risk” of the Recipient’s extraordinary success is also moderated by capping the total income payment at three times the amount of funding received.<sup>20</sup>

On May 6, 2014, Upstart announced that it would “sunset” these income-share agreements and focus exclusively on traditional lending.<sup>21</sup> Interestingly, the announcement noted that “while many regulatory and policy efforts are underway to facilitate the development of the market, these efforts will likely take many years.”<sup>22</sup> This Essay is a response to both the growth of this family of financing structures as well as to the conceptual and regulatory uncertainty that surrounds them. Our analysis is based on the Upstart income-share agreements offered through May 2014 (and which remain outstanding), as well as similar structures that continue to be offered.<sup>23</sup>

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*Will the Issuer Make Payments on a Loan-Related Security if There is a Payment Default Under the Corresponding Loan for the Related Security?*, UPSTART, <http://investorhelp.upstart.com/questions/83800-Will-the-Issuer-make-payments-on-a-Loan-Related-Security-if-there-is-a-payment-default-under-the-corresponding-loan-for-the-Loan-Related-Security> (last visited May 11, 2014).

17. The annual income amount that the Recipient agrees to share is her total income listed on IRS Form 1040, Line 22. See 2014 UPSTART AGREEMENT, *supra* note 15, at cl. 2.a.i. Significantly, not only does Line 22 include the Recipient’s wage income and business income, it also includes interest, dividends, alimony, and lottery winnings (i.e., income regardless of any connection to the Upstart proposal that attracted the Backers’ attention).

18. The 2013 Agreement also required that the Recipient not only pay the agreed percentage of the Recipient’s total annual income, but also a percentage of any equity-based deferred compensation received from her employer. See 2013 UPSTART AGREEMENT, *supra* note 15, at cl. 2.a.

19. 2014 UPSTART AGREEMENT, *supra* note 15, at cl. 2.b.i. The 2013 Agreement also included a hardship exemption for years in which the Recipient’s income dropped below twenty-thousand dollars even if the contract had previously been deferred five times for low earnings. No additional contract extension would be made in such circumstances. 2013 UPSTART AGREEMENT, *supra* note 15, at cl. 2.b.ii.

20. 2014 UPSTART AGREEMENT, *supra* note 15, at cl. 2.c. In the 2013 Agreement, which explicitly noted the option of a ten-year contract, the cap was five times the funding amount in the case of a ten-year agreement. 2013 UPSTART AGREEMENT, *supra* note 15, at cl. 2.c.

21. David Girouard, *Sunsetting Income Share Agreements on Upstart*, Upstart Blog, Upstart Blog (May 6, 2014), <http://blog.upstart.com/post/84980267394/sunsetting-income-share-agreements-on-upstart>.

22. *Id.*

23. See *supra*, note 6

*B. Fantex*

In October 2013, Fantex Inc. announced a trading platform that allows the public to acquire shares that track the brand performance of professional athletes. Fantex has announced stock offerings relating to NFL athletes Arian Foster, a Houston Texans running back; Vernon Davis, a San Francisco 49ers tight end; and E.J. Manuel, a Buffalo Bills quarterback.<sup>24</sup> In each case, the stock is or will be linked to the performance of the athlete's brand, including income earned from NFL contracts, endorsements, and appearance fees. Underlying each Fantex stock offering is a contract between Fantex and the athlete. Under this contract, the athlete receives a lump-sum amount upfront in exchange for a percentage of his future NFL-related income. For example, in a \$4.2 million IPO, Vernon Davis received \$4 million from Fantex upfront in exchange for a 10% stake in his future NFL earnings.<sup>25</sup> Although Fantex is actually offering Fantex, Inc. common stock in a transaction technically distinct from the contract between Fantex and the athlete, the popular press has been quick to characterize the Fantex deal as an opportunity for shareholders to acquire shares in a football player.<sup>26</sup>

The Upstart and Fantex transactions and others like them share important commonalities that differentiate them from traditional loans: all involve a transfer of immediate funding from investors to an individual in return for an indeterminate dollar amount of the individual's future earnings.<sup>27</sup> These arrangements are likely to proliferate, yet current law lacks an adequate theoretical framework for evaluating and regulating them. The absence of such a framework is troubling because it may allow the proliferation of more aggressive transactions that cross the line between permitted financing of human endeavors and excessive control of a person's human capital. Additionally, even transactions that raise no ethical concerns need to be analyzed for regulatory purposes. The operation of many legal and regulatory systems (including bankruptcy and tax law) depends on careful characterization and classification. As with the rise of financial derivatives in the late 1980s, a comprehensive examination is required to determine the appropriate legal treatment of these new human financing transactions.<sup>28</sup>

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24. See, e.g., Fantex, Inc. Form S-1 Registration Statement Under the Securities Act of 1933, SEC.GOV (Feb. 28, 2014), available at <http://www.sec.gov/Archives/edgar/data/1573683/000104746914001614/a2218564zs-1.htm>.

25. Fantex, Inc., Amendment No. 3 to Form S-1, Preliminary Prospectus, Summary, SEC.GOV, at 1 (Feb. 28, 2014), available at <http://www.sec.gov/Archives/edgar/data/1573683/000104746914001605/a2218546zs-1a.htm> (Registration Statement relating to E.J. Manuel offering).

26. 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.").

27. See *supra* notes 6 and 11 (referring to the Pave transaction).

28. See, e.g., Mark P. Gergen & Paula Schmitz, *The Influence of Tax Law on Securities Innovation in the United States: 1981-1997*, 52 TAX L. REV. 119 (1997); Jeff Strnad, *Taxing New Financial Products: A Conceptual Framework*, 46 STAN. L. REV. 569 (1993).

## II.

## ANALYZING THE TRANSACTIONS: THE ANALOGY TO EQUITY

At an instinctual level, and as noted in the popular press, transactions in which one sells a percentage of one's future earnings suggest enslavement, servitude, or bondage.<sup>29</sup> Although these deals do not and cannot create actual property rights in humans, they may nonetheless be problematic because they may create *indirect* ownership interests in human capital via financial contract. The question, therefore, is how to determine when a given contractual relationship so closely approximates property ownership that it is unethical and unconstitutional. In this regard, it is possible that these new human financing transactions are contractual interests analogous to equity ownership in a business enterprise.

Businesses generally raise capital by borrowing (i.e., debt financing) or by issuing shares or interests in exchange for a capital contribution (i.e., equity financing). Debt and equity often look similar because both are types of contractual interests issued in exchange for funding. Yet, debt and equity carry different connotations and are treated differently in areas such as tax and bankruptcy. In the corporate and partnership tax contexts, an equity interest suggests ownership of the entity as opposed to a mere creditor relationship. An equity owner is generally understood to have an interest in the upside of business performance but also greater exposure than debt holders to the downside of business failure.<sup>30</sup>

Thus, judicial doctrines have developed to determine whether a given relationship is debt or equity, regardless of the label bestowed by the parties. In the decades-long struggle to ascertain when a party purporting to be a creditor in fact is a firm owner, courts have relied on a multi-factor analysis to characterize these relationships based on their substance.<sup>31</sup> Typical factors include: intention of the parties, form of the instrument, whether the interest

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29. See *supra* notes 3–7 and accompanying text.

30. See, e.g., *Commissioner 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 paid independently of the risk of success, and gets a right to dip into the capital when the payment date arrives”); *TIFD III-E, Inc. v. United States*, 459 F.3d 220, 231 (2d Cir. 2006) [hereinafter *Castle Harbour*] (finding that foreign banks’ interest in the partnership “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” and that “[t]he banks had no meaningful stake in the success or failure of [the partnership]” that would indicate “equity participation”); JOINT COMM. ON TAXATION, 112th CONG., PRESENT LAW & BACKGROUND RELATING TO TAX TREATMENT OF BUS. DEBT 15 (Comm. Print 2011) (“Courts generally agree that the proper characterization of an instrument requires a facts and circumstances analysis, the primary goal of which is to determine whether, in both substance and form, an instrument represents risk capital entirely subject to the fortunes of the venture (equity), or an unqualified promise to pay a sum certain on a specified date with fixed interest (debt).”).

31. See, e.g., *Indmar Prods. Co. v. Comm’r*, 444 F.3d 771, 777 (6th Cir. 2006); *In re AutoStyle Plastics, Inc.*, 269 F.3d 726 (6th Cir. 2001) (using an eleven-factor test drawn from tax law to distinguish debt and equity); *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 696 (3d Cir. 1968) (citing *J. S. Birtz Constr. Co. v. Comm’r*, 387 F.2d 451 (8th Cir. 1967)).

rate is fixed, duration of the instrument and existence of a fixed maturity date, adequacy of the business' capitalization, extent of subordination to the claims of creditors, and allocation of risk between the parties.<sup>32</sup> These factors are weighed to determine whether an equity label is warranted. No single factor is determinative, and there is no bright-line rule that determines when a contract creates equity ownership in a business. Furthermore, even within a given field (i.e., bankruptcy or tax), the factors courts consider may vary depending on context. This multifactor analysis is useful in evaluating a capital-raising contract because many transactions contain elements indicative of both debt and equity. Critically, the multi-factor approach enables us to evaluate the substance of each individual transaction on a case-by-case basis.

The new human financing transactions have elements in common with business debt and business equity, making it possible to draw upon approaches adopted by courts in the debt-equity context to help determine when these new transactions cross the line into something problematic, such as human ownership. Part III provides a case study, using the Upstart transaction, that illustrates how debt-equity analysis might be applied in the human financing context.

### III.

#### CASE STUDY: APPLYING DEBT-EQUITY ANALYSIS TO THE UPSTART TRANSACTION

What does the application of these factors suggest about the new human financing transactions? A review of key debt-equity factors as applied to the Upstart case<sup>33</sup> reveals the following:

*Parties' Intentions/Transaction Label:* During 2013, Upstart contended that the contract with the Recipients created debt. The 2013 Upstart Agreement stated: "You understand and acknowledge that the funding amount is a debt owed to us."<sup>34</sup> However, contradictory portions of that same 2013 agreement foreshadowed Upstart's shifting position.<sup>35</sup> Upstart subsequently withdrew that claim in its 2014 version of the Agreement, stating in the contract: "This agreement is not a loan."<sup>36</sup>

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32. *Id.*

33. As noted in Part I.A, the analysis here is based on the Upstart income-share agreements offered through May 6, 2014 (and which remain outstanding).

34. 2013 UPSTART AGREEMENT, *supra* note 15, at cl. 2.d.

35. *See, e.g.*, 2013 UPSTART AGREEMENT, *supra* note 15, at cl. 2.a.i. The 2013 Agreement stated, in part: "[Y]our payment obligations are different from those of a traditional closed-end loan. You understand, unless converted, no interest is payable to us, and your monthly annual income payments will change each month and year depending on your total income in that month or year." 2013 UPSTART AGREEMENT, *supra* note 15, at cl. 2.d. The instrument could also be converted into traditional debt upon default. 2013 UPSTART AGREEMENT, *supra* note 15, at cls. 2.d, 15, 16.

36. 2014 UPSTART AGREEMENT, *supra* note 15, at Introductory Paragraph. Additionally, the Upstart website in 2014 reports that the classification of the Upstart agreement is not clear. *See How are the Securities Treated for U.S. Federal Income Tax Purposes?*, UPSTART, [https://upstart.helpjuice.com/questions/43094-\\*How-are-the-securities-treated-for-US-federal-income-](https://upstart.helpjuice.com/questions/43094-*How-are-the-securities-treated-for-US-federal-income-)

Although not definitive, Upstart's unwillingness to assert a firm debt characterization suggests that the transaction is not traditional debt.

*Interest Rate/Interest Payments:* The Upstart Agreement does not provide for a fixed interest rate or for payment of interest. Instead, the Recipient pays a specified percentage of the Recipient's total income annually (as calculated on Line 22 of IRS Form 1040). The absence of interest rates and set interest payments points toward equity characterization.

*Priority Relative to Other Claimants/Subordination:* Upstart receives the specified percentage of the Recipient's total income per IRS Form 1040 Line 22. Line 22 total income includes business net income, which takes into account business expenses, including allowable business interest, reported on IRS Schedule C. Thus, by referring to Line 22, the Upstart agreement anticipates that the Recipient will first have paid business interest and expenses before "sharing" income with Upstart. Such subordination of the Backer's investment to the payment of business expenses may suggest equity characterization.

*Duration:* The typical agreement term is five years.<sup>37</sup> This time frame is compatible with either equity or debt characterization.

*Risk Allocation:* An important element in debt-equity analysis is the allocation of risk, benefits, and burdens borne by the contracting parties. Traditionally, the more closely an investor's success is correlated with the success of the funding recipient, the more likely it is that the contract conveys equity ownership.<sup>38</sup> Here, the Backers benefit only to the degree that the Recipient succeeds financially. The Recipient pays a percentage of her income and may be excused from payment entirely in years in which her income is too low.<sup>39</sup> Thus, there is no guaranteed minimum payment or return. The Backer bears the risk that the Recipient will be financially unsuccessful. Moreover, if the Recipient is financially successful, the Backer can receive significant returns on its investment that exceed the rate of return on debt.<sup>40</sup> In these respects, the Upstart deal terms look more like equity than debt.

Based on this preliminary review of the Upstart transaction under the debt-equity framework, it would be difficult to characterize the transaction as

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tax-purposes (last visited May 11, 2014) ("The characterization of the funding agreements for U.S. federal income tax purposes is unclear.").

37. See *supra* note 15.

38. See, e.g., *Castle Harbour*, 459 F.3d at 231 ("[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. While their interest was not totally devoid of *indicia* of an equity participation in a partnership, those *indicia* were either illusory or insignificant in the overall context of the banks' investment.").

39. See *supra* notes 18–20 and accompanying text.

40. While there is an absolute ceiling on a Recipient's total payments to Upstart, this cap exceeds the return that would be available on debt. See *supra* note 20 and accompanying text.

debt because the Upstart structure contains several features that suggest equity ownership. However, this does not necessarily mean that the Upstart contract conveys an equity stake in the Recipients themselves. Debt-equity analysis must be more nuanced when applied to investments in people. The question with respect to these new human financing transactions is not just whether the instrument conveys a general ownership-like claim, but, more specifically, whether the contract replicates *direct property ownership of humans* in a way that would trigger ethical, legal, and regulatory concerns. A finding that a given transaction is not debt does not necessarily tell us what exactly the investors own. We must therefore refine the traditional debt-equity analysis to assess whether these transactions create a property ownership interest in humans.

The presence of four factors in particular would strongly suggest that a given human financing contract closely approximates human ownership. First, the duration of the contract is important. A contract that calls for payments for the remainder of the Recipient's life has different implications than one limited to five years. Second, the percentage of income due is also material. If an Upstart contract required payment of 80 percent of the Recipient's Form 1040 Line 22 income, the impact would differ from one that called for 7 percent. Third, the more control granted to the Backers over the Recipient's labor, investment, family, and lifestyle choices, the more the transaction might look like ownership. Finally, the base for sharing income under the agreement is relevant. An agreement that requires sharing income from a specific activity, investment, business or job intrudes less on a Recipient's independence and self determination than one that requires sharing a portion of all income generated by the individual.

Therefore, having determined that the Upstart transaction is not debt under the traditional business debt-equity test, we must examine these four factors to determine whether it constitutes equity in a human or, alternatively, some other type of equity-like interest. Although the Upstart Agreement does require payment based on Form 1040 Line 22 (i.e., all of the Recipient's income), the other three factors (length, percentage, and operational control) do not support a conclusion that the transaction approximates property ownership of a human. Thus, we conclude that the Upstart contract likely conveys a type of equity-like interest, but not one rising to the level of human ownership that ought to be banned.

The next logical question, which we explore in our future work,<sup>41</sup> is "what kind of equity-like interest has been conveyed?" That inquiry is not the subject of this Essay, which has focused on the threshold question of whether the new transactions are permissible and how we might make that assessment. However, the answer to the "what kind of equity-like interest?" question will be salient for purposes of regulating the transactions.

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41. See Oei & Ring, *supra* note 8.

## CONCLUSION

Debt–equity analysis is a particularly compelling frame through which to analyze the new human financing transactions because it illuminates their problematic ownership-like characteristics in a nuanced way. The Upstart example provides a helpful case study of how debt–equity analysis may be used to evaluate these new transactions. Importantly, the multifactor approach used in debt–equity analysis—particularly as refined to probe the human ownership aspects of these new transactions—does not demand a single universal conclusion. Rather, it allows for evaluation of each transaction on a case-by-case basis. In addition, the use of a factor-based approach can help pinpoint the most problematic features of a transaction. Ultimately, debt–equity analysis may be useful not just in answering the threshold question of whether the contracts should be permissible, but also in making subsequent judgments about what regulatory regimes should apply to arrangements otherwise deemed permissible.

Of course, the debt–equity framework has its limitations. Many individuals are already overleveraged (i.e., thinly capitalized),<sup>42</sup> and many traditional debt instruments exhibit equity-like features, such as high and variable interest rates. Thus, one might argue that the appearance of additional equity-like features in these new arrangements poses no greater risk and raises no new moral questions. Tax law’s debt–equity distinction has also been criticized on efficiency grounds due to the difficulty, at the margins, of establishing a meaningful line between debt and equity.<sup>43</sup> Finally, debt–equity analysis is not the only frame through which these transactions may be analyzed.<sup>44</sup>

Such arguments do not undermine the power of the debt–equity framework. First, these emerging structures demand careful scrutiny to ensure that they are not problematic in unprecedented ways. More broadly, the application of the multi-factor approach inherent in debt–equity analysis provides an occasion to reflect on the “hidden” ownership-like elements of

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42. See, e.g., David Bornstein, *A Way to Pay for College, With Dividends*, N.Y. TIMES OPINIONATOR ONLINE (June 2, 2011), <http://opinionator.blogs.nytimes.com/2011/06/02/a-way-to-pay-for-college-with-dividends/> (questioning whether traditional debt funding of education is more like servitude than human capital contracts).

43. See, e.g., David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627, 1627–28, 1638–39 (1999) (describing the case law on the debt–equity distinction as a “morass” and arguing that the debt–equity line should be drawn based on efficiency considerations rather than doctrinal or tax policy concerns).

44. That is, an arrangement that does not rise to the level of human ownership but also is not traditional debt may be characterized in a number of different ways. For example, the press has described the Fantex deal as insurance, in that the athlete diversifies against the risk of injury by entering into the contract. See, e.g., Sean Gregory, *Be Very Careful Buying Arian Foster Shares*, TIME (Oct. 18, 2013), <http://keepingscore.blogs.time.com/2013/10/18/be-very-careful-buying-arian-foster-shares/>; cf. Rachel Swan, *San Francisco Start-Up Drafts 49er Vernon Davis for IPO Roster*, SF WEEKLY (October 31, 2013), [http://blogs.sfweekly.com/thesnitch/2013/10/vernon\\_davis\\_fantex.php](http://blogs.sfweekly.com/thesnitch/2013/10/vernon_davis_fantex.php). For a more in-depth discussion, see Oei & Ring, *supra* note 8.

commonplace, existing financing transactions. This approach also allows us to critically examine the degree to which society is comfortable with individuals effectively surrendering personal autonomy and self-determination due to financial obligations and constraints. Second, just because line drawing may have efficiency costs does not mean that legislatures, courts and regulators should not draw lines. Other policy interests, including the need for effective regulation, may override efficiency considerations. Third, the ownership dimension of these transactions is so prominent that even if other characterizations are possible, the analogy to equity must be taken seriously.

In sum, despite potential shortcomings, debt-equity analysis remains a useful and highly critical lens. It may not be intuitive to think of these new transactions as issuances of shares in humans, even if they have equity-like characteristics. Yet, an equity designation may best reflect the underlying substance of at least some of these transactions. Given the potential for proliferation of these human financing structures, the possibility of equity characterization—with all of its uncomfortable implications—can no longer be ignored.