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Formulating Lists of Factors: Lessons from the Good, the Bad, and the U.C.C.

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INTRODUCTION

Many legal rules are, by necessity, imprecise and flexible. Some of these rules are grounded in equity or in notions of reasonableness, fairness, or justice, which makes precision impossible. Such rules are exceedingly common. Indeed, Article 2 of the Uniform Commercial Code (U.C.C.) alone uses some form of the words "material," "reasonable," "seasonable," and "substantial" in more than 100 different provisions.[1] It uses "good faith" as a description of a buyer's or seller's conduct (*i.e.*, not as a description of a transferee) an additional seven times.[2] There is nothing inherently bad about having a vague standard, although vagueness can make planning a transaction, advising a client, or resolving a dispute difficult.

Other legal rules are indeterminate for other reasons. Some apply to a wide range of transactions or facts, which also makes greater precision in formulating the rule challenging. Others deal with complex issues. For example, the law often disregards the form of a transaction if the transaction is, in economic reality, something other than what it purports to be. Thus, courts might recharacterize a loan as an equity investment,[3] treat a putative lease of goods as a secured sale,[4] regard a sale of receivables as a secured loan, or conclude that a sale of the assets of a business is, in reality, a de facto merger or other basis for imposing successor liability. Determining the economic substance of a transaction can be exceedingly difficult and often rests on nuances of fact.

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1. "Material" & "Materially": U.C.C. §§ 2-105(6); 2-107(2); 2-207(2); 2-209(5); 2-210(2); 2-311(3)(b); 2-504; 2-611(1); 2-616(1); 2-721. "Reasonable" & "Reasonably": U.C.C. §§ 2-201(2); 2-201(3); 2-204(3); 2-205,;2-206(1); 2-206(2); 2-207(1); 2-207(2)(c); 2-208(2) 2-209(5); 2-210(5); 2-302(2); 2-305(1); (3); 2-306(1); 2-309(1); 2-309(2); 2-309(3); 2-311(1); (3); 2-316(1); 2-317; 2-318 (Alternatives A, B & C); 2-319(3); 2-321(1); 2-327(1)(c); 2-328(3); 2-402(2); 2-503(1); 2-503(4)(b); 2-504(a); 2-508(2); 2-510(3); 2-511(2); 2-513(1); 2-515(a); 2-602(1); 2-602(2)(b); 2-603(1); 2-603(2); 2-604; 2-605(1); 2-606(1); 2-607(2); 2-; 607(3)(a); 2-608(1)(a); 2-608(2); 2-609(1); (2); 2-609(4); 2-610(a); 2-614(1); 2-615(b); 2-616(2); 2-704(2) 2-705(3)(a); 2-706(1); (2),;(3); 2-708(2); 2-709(1)(a); 2-710; 2-711(3); 2-712(1); 2-714(1); 2-715(1); 2-715(2)(a); 2-716(3); 2-718(1); 2-718(4); 2-723(2). "Seasonable" & "Seasonably": U.C.C. §§ 2-206(2); 2-207(1); 2-311(3); 2-319(3); 2-325(1); 2-327(1); 2-327(2); 2-503(4); 2-508(1); (2); 2-602(1); 2-605(1); 2-607(2); 2-607(5)(a); 2-608(1); 2-612(3); 2-615(c). "Substantial" & "Substantially": U.C.C. §§ 2-201(3); 2-210(1); 2-326(3); 2-327(2)(a); 2-608(1); 2-608(2); 2-610; 2-612(2); (3); 2-614(2); 2-616(1).

2. *See* U.C.C. §§ 2-305(2); 2-306(1); 2-311(1); 2-323(2)(b); 2-615(a); 2-706(1); 2-712(1).

3. *See infra* Part IV.

4. *See infra* Part V.

To deal with vague standards and imprecise rules, lawgivers – a term used herein to include those who draft legislation, author Restatements, or issue judicial decisions – frequently identify a list of factors to be considered. Such lists of factors are so ubiquitous in law that it is impossible to identify them all. They are used to address each of the issues mentioned in the previous paragraph, as well as to help resolve such diverse matters as:

- Whether a worker is an employee or independent contractor for the purposes of the Federal Insurance Contributions Act, the Federal Unemployment Tax Act, and the requirement for collecting income tax at the source;[5]
- Whether the use of another's trademark is likely to cause consumer confusion as to the true source of the user's goods;[6]
- Whether material involving a child is lascivious, and, thus, sexually explicit under the Protection of Children Against Sexual Exploitation Act;[7]
- Whether to issue a preliminary injunction;[8] and
- Whether a criminal defendant has been denied a speedy trial.[9]

Often, such a list of factors is referred to as a "test." That is far too generous. Describing a list of factors as a test implies that a review of the factors will, like dipping litmus paper in a liquid, reveal the answer to the question posed. That is rarely the case. Indeed, virtually every factor "test" that has been devised has been criticized for its failure to provide sufficient guidance and for its tendency to mask decisions based on other considerations.[10]

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5. *See* Rev. Rul. 87-41, 1987- 1 C.B. 296.

6. *See* Barton Beebe, *An Empirical Study of the Multifactor Tests for Trademark Infringement*, 94 CAL. L. REV. 1581 (2006) (criticizing many of the tests but declining to question the utility of multi-factor tests generally).

7. 18 U.S.C. § 2251. *See* United States v. Dost, 636 F. Supp. 828, 832 (S.D. Cal. 1986). For applications of the *Dost* factor test, *see* United States v. Villard, 885 F.2d 117, 122 (3d Cir. 1989); United States v. Wallenfang, 568 F.3d 649, 657–60 (8th Cir. 2009); Shoemaker v. Taylor, 730 F.3d 778, 785–87 (9th Cir. 2013).

8. *See, e.g.*, Winter v. Nat. Res. Def. Council, Inc., 555 U.S. 7, 20 (2008).

9. *See* Doggett v. United States, 505 U.S. 647, 670 (1992) (Thomas, J., dissenting) (criticizing a list of factors for evaluating speedy trial claims).

10. *See, e.g.*, John F. Hilson & Stephen L. Sepinuck, *A "Sale" of Future Receivables: Disguising a Secured Loan as a Purchase of Hope*, 9 THE TRANSACTIONAL LAWYER 14, 16 (2019) (discussing the list of factors used to distinguish a sale of future receivables from a secured loan); In re Keach, 243 B.R. 851, 869–70 (B.A.P. 1st Cir. 2000) (criticizing the11 factors commonly examined to determine whether a Chapter 13 bankruptcy plan is proposed in good faith and commenting that, "[i]n employing diverse factors and permitting a court to rely upon any one or more of the factors, the standard provides little guidance . . . . The public and the bar deserve something better then this legerdemain. To the extent the nature of a question allows, the rule of law should be a law of clear rules"); Reinsurance Co. of Am. v. Administratia Asigurarilor de Stat, 902 F.2d 1275, 1283 (7th Cir. 1990) (Easterbrook, J., concurring) (expressing reluctance to accept an approach that involves "throw[ing] a heap of factors on a table and then slic[ing] and dic[ing] to taste").

Rather than simply add to that heap of criticism, this article seeks to do something more constructive. It endeavors to provide guidance to lawgivers when formulating lists of factors. It does so by examining several problematic factor lists, and drawing lessons from them. The advice offered is not intended to be exhaustive.

I. MATERIAL BREACH – RESTATEMENT (SECOND) OF CONTRACTS § 241

Contract law treats many contractual promises, particularly those calling for sequential performance, as dependent. It does this by presuming that a party's remaining duties are conditioned on the absence of a material breach by the other party.[11] Consequently, the law distinguishes between a material breach, which does not affect the duty of the non-breaching party to render performance of its remaining duties, from material breach, which either suspends or discharges the remaining duties of the non-breaching party.[12]

Sometimes a breach consists of a failure to perform at all, and is thus obviously material. Other times it involves a small task but one that is nevertheless essential to the deal, and is also clearly material.[13] Nevertheless, in some situations distinguishing material from immaterial breach is more difficult. Moreover, because the rule applies to all kinds of contracts, providing definitive guidance on how to distinguish a material breach from an immaterial breach is nigh impossible. Instead, the Restatement (Second) of Contracts identifies the following five "significant" factors that courts and contracting parties should consider when dealing with the issue.

> 1) The extent to which the injured party will be deprived of the benefit which he reasonably expected;
>
> 2) The extent to which the injured party can be adequately compensated for the part of that benefit of which he will be deprived;
>
> 3) The extent to which the party failing to perform or to offer to perform will suffer forfeiture;
>
> 4) The likelihood that the party failing to perform or to offer to perform will cure his failure, taking account of all the circumstances including any reasonable assurances; [and]

11. *See* RESTATEMENT (SECOND) OF CONTRACTS § 237(AM. L. INST. 1981).

12. *See id.* cmt. a, § 225 cmt. a (AM. L. INST. 1981) (both explaining the consequence of failure of a condition).

13. In a television advertisement for the Milky Way candy bar, a man is depicted with a new tattoo spelled as "no regerts," rather than as "no regrets." That mere transposition of two letters is undoubtedly a material breach by the tattoo artist. *Milky Way Advertisement,* YOUTUBE (last visited Sept. 26, 2022), https://www.youtube.com/watch?v=6dIEr2TZIQ8.

> 5) The extent to which the behavior of the party failing to perform or to offer to perform comports with standards of good faith and fair dealing.[14]

The factors do not appear to be in order of significance. But there is a logic to their sequence: (i) the first two focus on the injured (*i.e.*, non-breaching) party; (ii) the last three focus on the breaching party.

On the other hand, there is an illogic – or at least an inconsistency – to their expression. The first factor – the extent the injured party will be deprived the benefit of the bargain – is phrased so as to point toward material breach. The greater the extent or likelihood the injured party will be deprived of the benefit of the bargain, the more likely it is that the breach is material. The remaining four factors are phrased so as to point toward immaterial breach. The greater the chance that the injured party can be compensated or that the breaching party will suffer a forfeiture, the less likely the breach is material.[15]

This is not a huge problem. It should not take long for a *thoughtful* reader to comprehend this. But law students sometimes struggle with it. And in other contexts, such as when a list of factors relates to a specific type of transaction with which the reader (*e.g.*, a judge) might be unfamiliar, even more experienced readers might get tripped up. In sum, inconsistency in expression creates unnecessary confusion. Accordingly, if possible, the factors should be expressed so that they point in the same direction.

II. "UNFAIR DISCRIMINATION" IN CHAPTER 13 – BANKRUPTCY CODE § 1322(B)(1)

Chapter 13 of the Bankruptcy Code authorizes a debtor's plan to separately classify unsecured claims, subject to the condition that the plan does not discriminate unfairly against any class.[16] The implication is that some disparate treatment of similar classes of claims is permissible,[17] but the Bankruptcy Code gives no guidance on when discrimination is fair and when it is unfair. In response, courts have repeatedly used the following four factors:

> 1) Is there a reasonable basis for the classification?
>
> 2) Is the debtor able to perform a plan without the classification?
>
> 3) Has the debtor acted in good faith in proposing the classification?

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14. *See* RESTATEMENT (SECOND) OF CONTRACTS § 241 (AM. L. INST. 1981).

15. The same schizophrenic phrasing appears in Section 4(b) of the Uniform Voidable Transactions Act, which identifies eleven factors relevant to whether a transfer was made with intent to hinder, delay, or defraud creditors. Ten are phrased in such a way as to suggest fraudulent intent; the eighth factor listed cuts against fraudulent intent.

16. 11 U.S.C. § 1322(b)(1).

17. *See* Stephen L, Sepinuck, *Rethinking Unfair Discrimination in Chapter 13*, 74 AM. J. BANKR. L. 341, 341 (2000).

> 4) How are the other claimants being treated? Specifically, are they receiving meaningful payment?[18]

On a substantive level, the appropriateness of some of these factors is questionable.[19] But even putting that aside, there are two, more generic problems worth noting about this list.

First, the factors are interrelated. For example, the reasonableness of a plan's discrimination (factor one) will necessarily be affected and informed by the necessity of that discrimination (factor two), as well as by how and how differently the disfavored claims are treated (factor four).[20] When listed factors interrelate so as to support one another, or worse, are redundant,[21] they tend to overemphasize a single consideration.

Second, two of the factors do not add anything meaningful. The reasonableness of the discrimination (factor one) necessarily depends upon the interests advanced in support of the discrimination, but the list makes no effort to identify what interests can and cannot justify it. The third factor purports to measure fairness in relation to good faith, but good faith itself requires a substantial measure of fairness.[22] In short, factors one and three purport to explain the meaning of one vague term (unfair discrimination) through the use of two other vague concepts (reasonableness and good faith). That is not helpful.

III. BREACH OF THE PEACE – U.C.C. § 9-609

Article 9 of the U.C.C. authorizes a secured party to repossess collateral without judicial process, provided that it proceeds without breach of the peace.[23] The term "breach of the peace" is not defined, so some courts have identified the following factors to consider:

> 1) Where the repossession took place;
>
> 2) The debtor's express or constructive consent;

18. *See id.* at 354–55, nn.74-80 (citing the various decisions for which the list of factors is named).

19. *See id.* at 358–59 (noting that several courts regard the second factor as inappropriate, that the third factor's inquiry into good faith is redundant with § 1325(a)(3), which makes good faith an independent requirement for confirmation, and that the fourth factor, even if appropriate when first identified, became outdated when Congress added § 1325(b) to the Bankruptcy Code to require debtors to either pay all claims in full or devote all their disposable income to the plan for at least three years).

20. *Id.* at 357–58 (making this point and citing authorities in support).

21. The same problem arises when a single factor is repeated, so that the list is redundant. The first and fourth factors used to assess breach of the peace under Article 9, *see infra* note 24 and accompanying text, are redundant.

22. *See Rethinking Unfair Discrimination in Chapter 13*, *supra* note 17, at 358. *See also* U.C.C. § 1-201(b)(20) (defining "goods faith" in part as the observance of reasonable commercial standards of "fair dealing").

23. *See* U.C.C. § 9-609(a), (b)(2).

3) Reactions of third parties;

4) The type of premises entered; and

5) The creditor's use of deception.[24]

There are two minor problems and one major problem with this list. The first minor problem is that this list is woefully incomplete, both in how individual factors are phrased and in the absence of other material factors. For example, the first factor refers to *where* the repossession occurs but ignores *when*, a clearly relevant consideration.[25] The second factor refers to the debtor's "consent," but that is only one end of a continuum of possible responses, ranging from consent to indifference or absence, through vocal opposition, all the way to physical obstruction or resistance. Surely, physical resistance is far more probative, perhaps even determinative, than the mere lack of consent. The third factor mentions the reactions of third parties but omits the effect on them. A repossession that injures third parties or damages their property will likely breach the peace even if those third parties do not "react" to that provocation. The unlisted but relevant factors include whether the repossession agent displayed a weapon[26] and whether a uniformed police officer without a writ assisted in the repossession.[27]

At a theoretical level, the incompleteness of this list should not matter because the list, like most lists of factors, does not purport to be exhaustive. But most judges are generalists, and courts can be somewhat formalistic when dealing with lists of factors. So, if possible, the list should be complete.

24. *See, e.g.*, Giles v. First Va. Credit Servs., Inc., 560 S.E.2d 557 (N.C. Ct. App. 2002).

25. *See* Hester v. Bandy, 627 So. 2d 833, 841 (Miss. 1993) (suggesting that the repossession agent's strategy to "repossess the van in the early morning hours . . . was a tactic which guaranteed generating fright or anger, or both, if discovered in progress by the [debtors]"). *But cf.* Mahdavi v. NextGear Cap., Inc., No. 1:14CV648, 2015 WL 1526538 (E.D. Va. Apr. 3, 2015) (repossession agents did not breach the peace by going to the debtor's home address at 1:00 am, hooking the debtor's car up to the tow truck, thereby gaining dominion and control over the car, knocking on the front door of the residence and asking for the keys, and then leaving after the debtor refused to give the agents her keys. The agents did not use any force, violence, threats, or fraud to obtain control over the vehicle); *Giles*, 560 S.E.2d at 560 (treating a repossession at 4:00 am as permissible as a matter of law).

26. *See, e.g.*, Wright v. Santander Consumer USA, Inc., No: 6:18-cv-263-Orl-22KRS, 2018 WL 2095171 (M.D. Fla. May 1, 2018).

27. *See* U.C.C. § 9-609 cmt. 3; McLinn v. Thomas County Sheriff's Dep't, 535 F. Supp. 3d 1087 (D. Kan. 2021); Richards v. PAR, Inc., 954 F.3d 965 (7th Cir. 2020); Hyman v. Capital One Auto Fin., 826 F. App'x 244 (3d Cir. 2020); Vassal v. Palisades Funding Corp., No. 19-CV-3241(EK)(RER), 2020 WL 2797274 (E.D.N.Y. May 28, 2020); Gable v. Universal Acceptance Corp., 338 F. Supp. 3d 943 (E.D. Wis. 2018); Murray v. Poani, 980 N.E.2d 1275 (N.H. 2012); Reinhart v. PNC Bank, No. 10–7384, 2012 WL 1104685 (E.D. Pa. Apr. 2, 2012); Siwka v. Smart Recovery Serv., LLC, No. 08-cv-12152, 2010 WL 4791370 (E.D. Mich. Oct. 28, 2010). *See also* Russell v. Santander Consumer USA, Inc., No. 19-CV-119, 2020 WL 3077944 (E.D. Wis. Jun. 9, 2020) (a repossession company, the company's agent, and the secured party were liable for breaching the peace during a repossession that occurred while the debtor was in police custody following a failed attempt to repossess thirty minutes earlier).

The second minor problem is that at least one factor is unclear as to which way it cuts. It seems likely that the court that identified these factors thought that deception (factor five) was a bad thing, so that its use would be more likely to make the repossession a breach of the peace. But that conclusion is not certain. The court provided no explanation of or justification for this factor. Moreover, deception might be unethical,[28] but it can be used to reduce the likelihood of a confrontation, and thus help ensure a peaceful process. Accordingly, judicial reaction to the use of deception to affect a repossession is mixed.[29] Listed factors should be clear as to how and why they impact the analysis.

The major problem is that the list of factors is divorced from a clear standard to which the factors relate. Unlike the terms "material breach" and "unfair discrimination," which are inherently vague but nevertheless understandable terms, "breach of the peace" is more of a legal label than a standard. It is intended to distinguish permissible repossessions from impermissible ones, but it does not really signal the distinction. Consequently, the list of factors instructs courts what to look ***at*** but not what to look ***for***.

That is very problematic. A list of factors to consider but no standard to apply provides courts with little real guidance and can instead be used to mask decisions based on other considerations. It is imperative that the list be preceded by a statement of what the factors are intended to determine. For example, a working definition of "breach of the peace" might be: "Actions that incite violence, disturb public repose, intimidate the debtor into surrendering possession of the collateral or the right to judicial resolution of a dispute, or are likely to do any of those things." Only when the issue is framed in such a manner can a list of factors be understandable and useful.

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28. *See* MODEL RULES OF PRO. CONDUCT r. 8.4(c) (AM. BAR ASS'N 1983) (declaring it to be "professional misconduct for a lawyer to . . . engage in conduct involving dishonesty, fraud, deceit or misrepresentation").

29. *Compare* Ford Motor Credit Co. v. Byrd, 351 So. 2d 557 (Ala. 1977) (breach of the peace occurred when a secured party induced the debtor, who disputed the existence of default, to drive to the dealership to discuss then matter and, while he was there, removed the automobile from where the debtor had parked it and locked it up in a storage area); *with* Pleasant v. Warrick, 590 So. 2d 214 (Ala. 1991) (no breach of the peace in tricking the debtor into revealing the location of the collateral on the belief that the creditor simply wanted to check on the collateral's condition). *See also* Aviles v. Wayside Auto Body, Inc., 49 F. Supp. 3d 216 (D. Conn. 2014) (implying in dicta that trickery should be avoided during repossession); Fleming-Dudley v. Legal Investigations, Inc., No. 05 C 4648, 2007 WL 952026 (N.D. Ill. Mar. 22, 2007) (debtor stated a claim for breach of the peace by alleging that repossession agent impersonated a police officer and threatened to file criminal charges against debtor); Mimnaugh v. Toyota Motor Credit Corp., No. 04 C 4607, 2005 WL 8179044 (N.D. Ill. Jul. 11, 2005) (although not all trickery and deceit during a repossession constitutes a breach of the peace, a debtor stated a claim for breach of the peace by alleging that a repossession agent: (i) impersonated a law enforcement agent by displaying an official-looking badge and referring to himself as "Agent Spicuzza"; and (ii) represented that the debtor would be arrested if she did not surrender the vehicle).

IV. RECHARACTERIZING DEBT AS EQUITY

Most businesses are financed through investment of equity, debt (*i.e.*, loans), or a combination of the two. In their pure forms, debt and equity have very different characteristics:

Attributes of Pure Debt	Attributes of Pure Equity
Structurally superior to equity	Structurally subordinated to debt
No voting rights	Voting rights
Liability	No liability
Limited upside	Unlimited upside

However, parties can structure an investment so that it has attributes of both. Common examples include non-recourse debt (for which there is no personal liability), preferred stock (which has limited upside and is structurally subordinated to debt but superior to other equity), and debt with a right to convert to equity (which has unlimited upside). Sometimes, the law treats debt very differently from equity,[30] in which case it becomes necessary to determine if the label used by the parties conforms to the economic reality of the investment. In other words, courts will, on occasion, recharacterize as an infusion of equity a transaction structured as a loan. In doing so, courts frequently consider the following factors:

1) The names given to the instruments;

2) The presence or absence of a fixed maturity date and schedule of payments;

3) The presence or absence of a fixed rate of interest and interest payments;

4) The source of repayments;

5) The adequacy or inadequacy of capitalization;

6) The identity of interests between the creditor and the stockholder;

7) The security, if any, for the advances;

8) The business's ability to obtain financing from outside lending institutions;

9) The extent to which the advances were subordinated to the claim of outside creditors;

10) The extent to which the advances were used to acquire capital assets; and

30. For example, only debt gives rise to an allowable claim in bankruptcy. *See* 11 U.S.C. §§ 101(5), (12), 502(b).

11) Presence or absence of a sinking fund to provide repayments.[31]

This list might be the worst list of factors currently in use for any purpose. That is partly because the relevance of at least four of the factors is highly questionable,[32] and two others are poorly phrased.[33] But far more important is that the list is not tied to a standard. And in this case, the absence of a standard is even more problematic than it is with respect to the list of factors used to determine breach of the peace.[34] The "breach of the peace" label gives courts at least some hint as to what they are to examine the factors for. Here, the issue fails to do even that. This list tells a court what to look at but no guidance at all on what to look for. The list needs to be prefaced by a standard. Of course, courts might have developed this list because identifying common differences between debt and equity is far easier than articulating a standard that truly distinguishes between those two types of investment. But that is no excuse. Without some explanation of the fundamental distinction between

31. In re Dornier Aviation (North America), Inc., 453 F.3d 225, 233–34 (4th Cir. 2006) (using these factors to distinguish debt from equity for bankruptcy purposes); In re AutoStyle Plastics, Inc., 269 F.3d 726, 749–50 (6th Cir. 2001) (same); Roth Steel Tube Co. v. Comm'r, 800 F.2d 625, 630 (6th Cir. 1986) (using these factors to distinguish debt from equity for federal income tax purposes). *See also* In re SubMicron Sys. Corp., 432 F.3d 448, 456 n.8 (3d Cir. 2006) (citing similar lists that other courts have used); In re Hedged-Invs. Assocs., Inc., 380 F.3d 1292, 1298 (10th Cir. 2004) (using a slightly different list of thirteen factors).

32. How the investment is labeled (factor one) should not be relevant. The transaction documents will always refer to the investment as a loan. That is because no one seeks to re-characterize equity as debt; the issue is invariably whether a transaction structured as a loan is really an investment of equity. Put another way, if the transaction documents refer to the investment as equity, it is. If the transaction documents refer to the investment as debt, that should be irrelevant because the determination is based on economic realities.

The existence of security for the investment (factor seven) is seemingly relevant because equity is not normally supported by security whereas debt often is. But in context, this factor often becomes less relevant. For example, if the security interest is completely underwater or if for other reasons the investor would never extract value from the collateral, the grant of a security interest should not matter.

The ability of the business to obtain debt financing from other sources (factor eight) is not relevant. Often insiders are the only source of new investment for a business or are willing to provide it on better terms. If that is the case, it is not clear why that is relevant to whether the investment is debt or equity. At most, this factor speaks to the risk of the investment. But if risk is a relevant consideration, it should be identified as such and not imputed indirectly through a proxy factor.

The extent to which the investment is used to acquire capital assets (factor ten) is totally irrelevant. Both debt and equity investments are regularly used for this purpose, so this factor does not help distinguish between the two types of investment.

33. Factor three refers to a "fixed rate of interest." If "fixed" means "specified," then perhaps that factor is an appropriate consideration. A transaction structured as a loan but for which no interest rate is specified does not look like a real loan. But if "fixed" means "constant," as distinguished from "variable," the factor is irrelevant. Whether the investment call for interest at a constant rate or a variable rate does not matter to whether the investment is a loan or an infusion of equity (unless perhaps the interest rate is tied to the profit of the business).

Factor eleven looks are the presence or absence of a sinking fund. Sinking funds are rarely used. The presence of a sinking fund might suggest that the investment is a debt, but the absence of a sinking fund does not.

34. *See supra* notes 23–29 and accompanying text.

debt and equity, this list of factors is essentially meaningless, and courts that examine the factors are engaging in a hollow analysis.[35]

One possible way to phrase the fundamental distinction between debt and equity is as follows:

> An investment structured as a loan to a business is really an infusion of equity only if a return on the investment is, after considering all relevant factors, contingent on, or based on the amount of, profit. An investment structured as a loan is not an infusion of equity merely because a return on the investment is contingent on revenue, the liquidation of assets, take-out financing, or new equity contributions.

Such a standard would provide far more guidance to courts than any list of factors could. Alternatively, such a standard would help courts apply an accompanying list of factors in a meaningful and consistent way. But the point of this article is not to distinguish debt from equity, and hence not to prove that this standard is the best way to articulate the distinction. It is merely to show that courts must know what they are looking *for*, not merely what they are to look *at*.

V. LEASE VS. SECURITY INTEREST – U.C.C. § 1-203

A credit sale of goods (in connection with which the seller retains a security interest in the goods) and a lease of goods can look quite similar. In both transactions, one party pays for possession and use of the goods over time, while the other party has a right to take the goods back if payment is not made. Yet the law treats the two transactions quite differently. A lease of goods is governed by Article 2A of the U.C.C., whereas a sale with a retained security interest is governed by Articles 2 and 9 of the U.C.C. A lessor need not file a financing statement against the lessee to protect its interest in the goods, but a seller ordinarily must.[36] And in bankruptcy, the rights of a lessor are substantially different from the rights of a secured creditor. Accordingly, it is often necessary to distinguish a credit sale from a lease.[37]

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35. *See* Matthew D. Siegel, *Debt Recharacterization Looks Back on a Good Year*, 26-FEB AM. BANKR. INST. J. 1 (2007) (noting that "[d]ebt recharacterization is apparently here to stay, even though the case law still fails to provide a coherent legal framework to guide its exercise," and suggesting that the ultimate issue as whether the loan resulted from arm's-length negotiation). *See also* In re Dornier Aviation (North America) Inc., 453 F.3d 225, 234 (4th Cir. 2006) (indicating that all the factors speak to whether the transaction reflects the characteristics of an arm's length negotiation).

36. The seller's retained security interest would be automatically perfected without the need to file a financing statement if the goods are consumer goods in the hands of the buyer. *See* U.C.C. §§ 9-103 (defining "purchase-money security interest"), 9-309(1) (a purchase-money security interest in consumer goods is automatically perfected).

37. The same issue can arise with respect to real property. For example, the summary proceedings available to evict a tenant might not apply if the putative lease is really a sale with a mortgage, and the court with subject matter jurisdiction to hear the putative landlord's claim to recover the property might be different. *See, e.g.*, Vic's Antiques and Uniques, Inc. v. J. Elra Holdingz, LLC, 143 N.E.3d 300 (Ind. Ct. App. 2020) (treating a 20-year lease of real property with

Section 1-203 of the U.C.C. provides rules and guidance on how to distinguish a sale from a lease. It does so not through a list of factors per se, but through five subsections that collectively identify some determinative and some non-determinative factors, specifically:

- Subsection (a) states that the determination depends upon the facts of the case;
- Subsection (b) identifies four circumstances in which the transaction definitively creates a security interest;
- Subsection (c) lists six contractual terms that are not to be regarded as determinative, although they might still be relevant; and
- Subsections (d) and (e) contain some guidance on the meaning of phrases found in subsection (b).[38]

But as with the lists of factors used to determine whether a repossession involves a "breach of the peace" or whether an investment in a business is debt or equity, Section 1-203 fails to state what the critical distinction between a sale and a lease is. So, when the safe harbors in subsection (b) do not apply, and the analysis reverts to the all-the-facts-and-circumstances inquiry in subsection (a),[39] the section fails to provide the guidance it should. In short, subsection (a) tells judges to look *at* everything, but not what to look *for*.

The omission of the relevant standard is somewhat surprising in this case because the standard is not difficult to articulate. Courts and commentators frequently describe the issue as whether the putative lessor "has retained a meaningful reversionary interest in the goods."[40] A more complete phrasing might be:

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an option to purchase for $1 at the end of the lease term as a sale with a retained mortgage, rather than as a lease).

38. Subsections (d) and (e) do *not* contain definitions. Neither state what a word or phrase "means." The first sentence of subsection (d) indicates that consideration is "nominal" in a specified situation and the second sentence indicates that consideration is not "nominal" in two specified situations. Even collectively, these sentences are not a definition because they do deal with all possible circumstances. When neither sentence applies, the subsection simply provides no guidance on whether consideration is or is not nominal. This point is analogous to a tenet of basic logic. Each sentence is phrased, in essence, as "if X, then Y." Such a statement provides no guidance about what the happens if the stated condition is not true. In other words, if not X, then nothing certain follows. For much the same reason, subsection (e) does not define anything either.

39. *See, e.g.*, In re Grubbs Constr. Co., 319 B.R. 698 (Bankr. M.D. Fla. 2005) (applying the economic realities test after the safe harbor rules in subsection (b) failed to conclusively classify a purported lease transaction as a sale and secured transaction; transaction was not a lease because only economically sensible course for debtor was to exercise early buyout option); Coleman v. Daimlerchrysler Servs. of N. Am., LLC, 623 S.E.2d 189 (Ct. App. 2005) (when subsection (b) does not apply, all the facts and circumstances must be examined).

40. *See, e.g.*, In re Worldcom, Inc., 339 B.R. 56, 71 (Bankr. S.D.N.Y. 2006) (quoting Addison v. Burnett, 49 Cal. Rptr. 2d 132, 136–137 (Cal. Ct. App. 1996)). *See also* In re Schultz, No. 22-20090-dob, 2022 WL 16752855, at *4 (Bankr. E.D. Mich. Nov. 7, 2022) (if the lessor has "a meaningful reversionary interest . . . the parties have signed a lease, not a security agreement. If

> A transaction structured as a lease of goods is not a lease if, at the inception of the transaction, there is no reasonable possibility that the lessor will receive the goods back while the goods have more than nominal value.

But Section 1-203 does something worse than omit the standard; it frames the issue in a misleading way. The issue is how to distinguish between a lease of goods from a sale.[41] Yet the section, through both its caption[42] and its first sentence, frames the issue as how to distinguish a lease from a security interest.[43] Whereas a lease and a sale can be structured in very similar ways, a lease and a security interest bear no resemblance to each other.[44] Consequently, phrasing the issue in that manner obfuscates rather than helps. If the omitted standard had been included, it is unlikely that this misleading phrasing would have been used.

CONCLUSION

Lawgivers are likely to continue to use and develop lists of factors to help resolve legal issues. Such lists can be useful. After all, most judges are generalists, who can be and are called upon to hear and decide cases on almost any legal issue. They need guidance on how to resolve legal issues they did not face before ascending to the bench and which they might encounter only once or twice while sitting there.

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there is no reversionary interest, the parties have signed a security agreement, not a lease") (quoting In re QDS Components, Inc., 292 B.R. 313, 332-33 (Bankr. S.D. Ohio 2002)); Huntington Tech. Fin., Inc. v. Neff, No. 3:18-CV-01708 (VLB), 2020 WL 1430092, at *11 (D. Conn. Mar. 24, 2020) (quoting 4 WHITE & SUMMERS ON THE UCC § 30:14 n.1 (6th ed. 2019)); In re Tate, No. 2:11-bk-74591, 2012 WL 13135232, at *3 (Bankr. W.D. Ark. Sept. 21, 2012); In re Cole, 100 B.R. 561, 564 (Bankr. N.D. Okla. 1989); Robert W. Ihne, *Seeking a Meaning for "Meaningful Residual Value" and the Reality of "Economic Realities"– An Alternative Roadmap for Distinguishing True Leases from Security Interests*, 62 BUS. LAW. 1439 (2007).

41. Even when the transaction purports to involve a finance lease, it is appropriate to view the distinction as one between a lease and sale. The putative lessor's role in the transaction is that of lender, rather than as a lessor or seller, but the central issue remains whether the transfer is a sale or lease and whether the transferee is a buyer or a lessee.

42. In the U.C.C., section captions are deemed to be part of the of the statutory text. U.C.C. § 1-107.

43. If a transaction structured as a lease is in reality a sale, the leasing structure necessarily means that the lessor (now seller) has retained a security interest. That is because a lessor, by definition, retains title to the property leased, and retention of title by a seller of goods is limited in effect to the retention of a security interest. *See* U.C.C. §§ 1-201(b)(35), 2-401(1).

44. In both a true lease of goods and a sale of goods structured as a lease, one party is transferring an interest in the goods to the other. The distinction quite obviously rests on the nature of the interest being transferred. But analyzing that transaction as a distinction between a lease and a security interest veils the similarity because it purports to compare transfers by different parties. When a lease of goods is recharacterized as a sale, and the seller's retention of title operates as a security interest, it is the buyer that, in effect grants the security interest. Hence, a lease involves a transfer of property rights from the lessor to the lessee, but a security interest arising from a transaction so structured involves a transfer of property rights in the opposite direction. It is not surprising, therefore, that people get confused by the lease vs security interest phrasing of the issue.

But lists of factors should be identified with care. It should go without saying that the lawgivers who identify the factors should ensure that each factor listed is truly relevant and is phrased with the precision appropriate to any legal text. But beyond that, lawgivers should heed the following advice:

1) If possible, phrase the factors so that they all lead to the same conclusion.

2) Avoid factors that are interrelated, redundant, or use one vague term to explain another vague term.

3) Make the list as complete as possible.

4) Preface the list with the applicable standard (what to look for, not merely what to look at).

5) Do not obscure the standard.

The fourth item is by far the most important. All too often, or so it seems, lawgivers create a list of factors because developing the applicable standard is difficult. In other words, they create a list as a substitute for a standard simply because creating the list is easier. Telling people what to look at is far less work than telling them what to look for. But the more difficult it is to develop a coherent standard, the greater the need for it and, concomitantly, the less valuable a list of factors without a standard is.