True Sales or Secured Transactions? The Contract is Not Dispositive

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Introduction

Receivables are debts owed to a company for goods or services. A company seeking liquidity may sell the future interest in receivables generated through operations or use the future interest in receivables as collateral to secure a loan. The parties’ rights will vary depending on whether the receivables are sold or used as collateral. If sold, the buyer holds absolute ownership of the acquired receivables protected from other interests. If the transaction is a loan, the lender holds a security interest in the receivables, which may be junior to other interests.

A bankruptcy court can recharacterize a transaction as a sale or loan irrespective of the language used in the contract. This memorandum explores the present question by assessing the different approaches used to determine if a transaction is a sale or loan. The memorandum addresses the tests used in three bankruptcy cases by bankruptcy courts applying Montana, New York, and Illinois law. The cases chosen illustrate the current landscape of the true sales doctrine. Courts use different multi-factored tests and key factors but irrespectively courts focus on the substance of a transaction above form.
Discussion

A. Bankruptcy Courts can Determine Whether a Transaction is a Sale or Loan

The United States Supreme Court has stated that bankruptcy courts are “a court of equity,” which apply “the principles and rules of equity.”¹ The Supreme Court has further refined the role of bankruptcy courts finding that “equitable powers [that] remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code.”² Accordingly, courts have held that bankruptcy courts are empowered to determine whether a transaction is a sale or a loan.³ However, to make such determination, bankruptcy courts must turn to state law because “[n]either the Bankruptcy Code nor any other federal statute prescribes how to differentiate true sales from loans.”⁴ “Absent a contrary rule in the Bankruptcy Code, the contours of claims and property rights in bankruptcy cases are sculpted by applicable nonbankruptcy law.”⁵ Thus, different states have taken different approaches to determine whether a transaction is a sale or loan due to the lack of a uniformed federal approach.

B. Jurisdictions with Multi-Factored Tests.

Bankruptcy courts in most jurisdictions judge the substance of a transaction to determine if a transaction is a true sale or loan. Bankruptcy courts have formulated holistic multi-factored tests to guide the fact-intensive determination of a transaction’s “substance . . . [and] essential character.”⁶ However, there is no uniform test.⁷ And the tests employed by bankruptcy courts

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⁴ Id. at 7.
⁵ Id.
⁶ Id. at 9.
⁷ See id.
differ in different jurisdictions. Courts have found the test proposed by Richard D. Aicher and William J. Fellerhoff influential when establishing their tests.

The bankruptcy courts that have established multi-factored tests give deference generally to: (1) the intent of the parties; (2) the level of recourse (otherwise defined as risk); and (3) the adequacy of the purchase price (relative to both the debt and equity markets). The courts judge the substance and intent of parties surrounding a transaction “rather than... the form and color which the parties have seen fit to give it.”

1. U.S. Bankruptcy Court for the District of Montana Approach

In In re Shoot the Moon, LLC, the U.S. Bankruptcy Court for the District of Montana was confronted with the issue of whether a transaction was a sale or a loan. The Montana bankruptcy court adopted the factored test as presented in Richard D. Aicher and William J. Fellerhoff’s article. The court pronounced the adoption of the factors presented in Aicher and Fellerhoff’s article and emphasized that none of the factors are dispositive.

(1) whether the buyer has a right of recourse against the seller;
(2) whether the seller continues to service the accounts and commingles receipts with its operating funds;
(3) whether there was an independent investigation by the buyer of the account debtor;
(4) whether the seller has a right to excess collections;
(5) whether the seller retains an option to repurchase accounts;
(6) whether the buyer can unilaterally alter the pricing terms;

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10 See In re Shoot the Moon, LLC, 2021 WL 4144933, at *7; In re Dryden Advisory Grp., LLC, 534 B.R. at 623.
11 See In re Shoot the Moon, LLC, 2021 WL 4144933, at *13; The Transfer of Receivables (“Most courts, however, de-emphasize the language used in a document, and consider intent and actual conduct more relevant”).
12 See In re Shoot the Moon, LLC, 2021 WL 4144933, at *2.
13 See id. at *11.
14 See id.
(7) whether the seller has the absolute power to alter or compromise the terms of the underlying asset; and
(8) the language of the agreement and the conduct of the parties.\textsuperscript{15}

The \textit{Shoot the Moon} Court found that several factors demonstrated that the debtor had entered into an agreement to borrow money. First, the creditor retained a definite right of recourse against the debtor, consistent with a debtor-creditor relationship.\textsuperscript{16} Second, the debtor made payments to the creditor from an account that commingled operating accounts with receivables.\textsuperscript{17} The debtor commingling receivables with operating accounts would be uncommon if the creditor owned the receivables outright.\textsuperscript{18} Third, the contract granted the creditor conditional recourse, commonly depicted in loan agreements.\textsuperscript{19} Fourth, the creditor had complete protection while the debtor held the entirety of the risk, which further portrayed the characteristics of a loan.\textsuperscript{20}

Moreover, the court acknowledged the evidence was not entirely one-sided.\textsuperscript{21} The multifactored test adopted by the court necessitates a fact-intensive inquiry that will produce evidence pointing in both directions.\textsuperscript{22} Accordingly, the totality of evidence suggested the transaction was a loan, contrary to the contract, which stated the transaction was a sale.\textsuperscript{23} The court, holding that the transaction was a loan, reasoned that “simply calling transactions sales does not make them so because labels cannot change the true nature of the underlying transactions”).

\textsuperscript{15} Id. at *8.
\textsuperscript{16} See id. at *13.
\textsuperscript{17} See id.
\textsuperscript{18} See id.
\textsuperscript{19} See id. at *11.
\textsuperscript{20} See id.
\textsuperscript{21} See id. at *12.
\textsuperscript{22} See id. at *8.
\textsuperscript{23} See id. at *13.
2. U.S. Bankruptcy Court for the Middle District of Pennsylvania Approach.

The United States Bankruptcy Court for the Middle District of Pennsylvania was also confronted with how to approach the issue of whether a transaction is a sale or loan. In *In re Dryden Advisory Grp.*, both parties agreed to be governed by New York state law. Hence, the court articulated New York’s three-pronged test to determine if the transaction was a true sale or a secured transaction. First, the court concluded, “if receivables are commingled with the seller’s general operating funds, a loan rather than a sale is suggested.” Second, the ability of the purported buyer to “receive payment directly from account debtors supports that [a] transaction is a sale.” Third, the court emphasized, “that the most important single factor when determining whether a transaction is a true sale is the buyer’s right to recourse against the seller.” Accordingly, in the event a purported buyer of receivables does not retain “the risk of non-payment, it is more likely that the transaction will be characterized as a loan.” “One of the core attributes of owning a receivable is the risk that it will not be paid.”

The *In re Dryden Advisory Grp., LLC* opinion illustrates the fundamental role which risk and recourse play in classifying whether a transaction was a sale or loan. “Generally, if there is a full right of recourse against the seller, this weighs in favor of the existence of a loan because there is no transfer of risk.” Ultimately, the Pennsylvania bankruptcy court determined the

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25 See id. at 621 n.8.
26 See id. at 621.
27 See id. at 622.
28 See id.
29 See id. at 623.
30 See id.
31 See id.
32 See id.
33 See id.
transaction was a sale, and not a loan, based on applying the facts to New York’s three-pronged test.\textsuperscript{34}


The United States Bankruptcy Court for the Northern District of Illinois also was faced with the determination of whether a transaction was a sale or loan.\textsuperscript{35} The Illinois bankruptcy court, in \textit{Doctors Hospital of Hyde Park}, found \textit{The Transfer of Receivables} influential in determining the multi-factored test (analogous to Montana and New York).\textsuperscript{36} The court focused on the economic characteristics and reasonableness of the transaction and rejected the importance of labels found in a signed sale agreement.\textsuperscript{37}

The court explained, “[i]n general, [a sale or loan] review focuses on the economic substance of the transfer, particularly whether sufficient indicia of ownership of the assets shifted from the seller to the special purpose entity; giving less weight to labels attached to the transaction by the parties.”\textsuperscript{38} “Therefore, it is important to focus on whether a transaction was at arms'-length and commercially reasonable.”\textsuperscript{39} The court used the following factors to determine if the transaction was a sale or a loan:

- (1) Recourse or ‘transfer of risk of loss’;
- (2) Post transfer control over assets and administrative activities;
- (3) Accounting treatment “whether the transfer must be treated as a sale on the transferor’s books;
- (4) Adequacy of consideration; and
- (5) Parties Intent.\textsuperscript{40}

\textsuperscript{34} See id. at 627.
\textsuperscript{36} See id. at 709.
\textsuperscript{37} See id.
\textsuperscript{38} See id.
\textsuperscript{39} See id.
\textsuperscript{40} See id.
Ultimately, the court determined the transaction was a true sale.41 The court’s five-factor test was distinct from the New York and Montana tests. However, the three courts all focused on the substance of the transaction above the form. Also, all three courts considered the economic characteristics of the transaction and the intent of the parties. Most bankruptcy courts that employ a multi-factored test to analyze true sale versus loan distinctions are influenced by The Transfer of Receivables and focus on the intent and economic characteristics of the transaction.42 Nonetheless, each jurisdiction has tailored its precedent and its respective approach.

Conclusion

The method bankruptcy courts use to determine whether a transaction is a sale or loan varies based on the governing jurisdiction. Most bankruptcy courts have employed different multi-factored approaches with influence from The Transfer of Receivables. Therefore, jurisdictions with multi-factored tests typically share substantive characteristics. The factors frequently include: (1) the intent of the parties; (2) the allocation of risk; and (3) the purchase price’s adequacy. However, the factors vary among courts.

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41 See id. at 722.