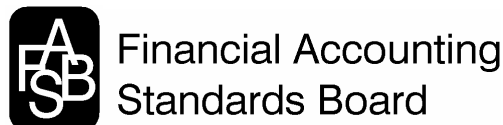


## MINUTES



**To:** Board Members

**From:** Statement 140 Amendment Team  
(Gagon, Ext. 322)

**Subject:** Minutes of the May 25, 2004  
Public Roundtable

**Date:** June 3, 2004

**cc:** Bielstein, Smith, Petrone, Leisenring, Project Team, Mahoney,  
Thompson, Vincent, Sutay, Gabriele, Swift, Polley, FASB Intranet  
(e-mail)

Topic: Qualifying Special-Purpose Entities:  
Legal Isolation and Setoff Rights

Basis for Discussion: FASB Staff Request for Information  
Relating to the Isolation of Transferred  
Assets in Connection with Its Qualifying  
Special-Purpose Entity Project to Amend  
FASB Statement No. 140, *Accounting for  
Transfers and Servicing of Financial  
Assets and Extinguishments of Liabilities*,  
dated April 9, 2004

Length of Discussion: 9:00 a.m. to 11:55 a.m.

Attendance:

Board members present:	Herz, Trott, Schipper, Batavick, Seidman, and Schieneman
Board members absent:	Crooch
Staff in charge of topic:	Smith
Other staff at Board table:	Donoghue, Lott, Lusniak, and Gagon
Outside participants:	Refer to the Attachment

**Summary of Decisions Reached:**

The Board held a public roundtable meeting with attorneys to discuss issues related to the isolation requirement of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, including the impact of setoff rights. Board members and participants expressed their views, but no decisions were reached.

**Objective of the Roundtable**

The objective of the roundtable was to gather more information on legal issues affecting isolation of financial assets. The objective of the meeting was met. Certain issues related to regulated financial institutions will be further discussed at a second roundtable on June 17, 2004.

**Matters Discussed and Decisions Reached:**

*The following text summarizes participant responses to questions posed by Board members at the public roundtable and topics discussed; however, this summary does not include direct quotes from that meeting. The questions may not be in the specific order in which they were discussed at the meeting.*

*It should also be noted that all participants provided disclaimers that the views they expressed at the roundtable were their own and did not necessarily represent the views of the organizations with which they are associated.*

**1. How Are Setoff Rights Currently Considered in True Sale Analyses?**

Participants indicated that setoff rights are *not* a determinative factor in rendering true sale opinions. All participants are aware of setoff issues, but for the most part do not believe that setoff impacts whether transferred assets would be considered a legal sale. Most participants agree that setoff rights impact the valuation of the asset, but would not preclude providing a true sale opinion. Participants argued that the potential exposure to setoff rights is an intrinsic part of individual assets and that the transferee should do adequate due diligence in its valuation of the assets, including analysis of obligor defenses to payment such as setoff rights.

They also noted that while setoff may cause an asset transferred in a legal true sale to be reclaimed by an individual creditor, the assets subject to setoff are not available to the general creditors of the transferor.

Most participants agreed that a well written participation agreement can transfer property rights in an asset to the transferee so that the transferred portion would not be included in the transferor's estate in the event of bankruptcy or receivership. Participants described a well written participation agreement as one that, among other things, shows a transferor's intent to sell the asset, has no or very little recourse, and limits what the transferor can do with the loan or participation agreement.

Board members expressed concern about relying on the intent of the parties when determining if something has been sold. They referenced FASB Statement No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse*, and stated that one of the reasons Statement 77 was superseded was because it depended too much on whether a transfer was purported to be a sale when determining whether to derecognize an asset. Participants stated that intent was only one indicator of a true sale; many things other than expressed intent are considered before a true sale opinion will be given by an attorney.

Finally, members of the Board and staff stated that for accounting purposes, setoff rights are an impediment to sale treatment. Both the Board and participants recognize that there is a fundamental difference in what lawyers deem to be true sales and the isolation requirement in Statement 140. One Board member stated that the Board needs to determine whether a true sale opinion is sufficient to achieve sale accounting or if other criteria need to be considered.

## **2. Can Setoff Rights Be Eliminated?**

The ability to eliminate setoff rights will vary on several circumstances, key variables include whether the instrument is negotiable and whether the obligor<sup>1</sup> is a consumer or a commercial entity. In certain cases, setoff rights can not be eliminated as a matter of law.

Participants agreed that waivers of setoff rights by the obligor are generally enforceable against the obligor. However, waivers would likely need to be signed when the instrument is originated, which may be impractical in some circumstances. Participants stated that setoff rights can be eliminated when an applicable state law says that they can be eliminated. Federal bankruptcy courts will generally honor the applicable state law.

Notice to the obligor can effectively eliminate setoff rights that accrue after notice is provided to the obligor of the transfer; the rights that accrue before the notice will still be enforceable, absent other facts such as waiver of those rights by the obligor. In transactions protected by consumer credit laws, notification of a transfer of either a negotiable or a nonnegotiable instrument may not eliminate setoff rights.

## **3. Does a Transfer of an Entire Financial Asset Break Mutuality and, therefore, Eliminate Setoff Rights, or is Notification Required?**

Some participants stated that if a negotiable instrument is properly negotiated to a holder in due course, setoff rights would be eliminated. However, if the instrument is nonnegotiable, a transfer alone would not be sufficient to eliminate the obligor's right of setoff. Notification of the transfer must also be given to the obligor. In the case of both negotiable and nonnegotiable instruments, however, some participants stated that if the transfer was subject to consumer protection laws by the Federal Trade Commission, setoff rights would not be eliminated if the asset was transferred to a third party, regardless of how the transfer occurred. There

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<sup>1</sup> For purposes of this discussion, obligor refers to the party other than the transferor. In fact, both parties in a mutual debtor-creditor relationship are obligors.

was also discussion that the transferor's setoff rights may be eliminated by a transfer but the obligor's setoff rights may not.

Other participants suggested that setoff rights are divided into those rights that follow a transfer and those that do not follow a transfer. Some participants stated that a common-law right of setoff does not follow a transfer. That is, if an entire asset is *transferred*, common-law setoff rights are eliminated because there is no mutuality between the obligor and transferor. One proponent of this view stated if an asset is transferred, mutuality is broken and setoff rights are immediately eliminated regardless of whether notification has been given to the obligor, others disagreed. Proponents of this second view did not distinguish between negotiable instruments and nonnegotiable instruments in evaluating whether a transfer of a whole asset eliminates setoff rights.

#### **4. Has a Transfer Taken Place in a Normal Participation?**

Participants indicated that the real issue the FASB needs to address is whether there has been a transfer of the asset and that the issue of setoff rights is a red herring, not the underlying problem. There were divergent views concerning the answer to this question among participants at the roundtable.

Some participants stated that in a typical participation agreement, the underlying asset has not been transferred by the transferor. Case law determines whether there was a sale or not, and the cases indicate that in a participation, the underlying asset has not been sold. Proponents of this view argue that Statement 140 is based only on the underlying assets, and that in a participation, they couldn't give a true sale opinion on the underlying assets.

Other participants disagreed and noted that there are "good" participation agreements that achieve a legal sale of an asset and that there are "bad" participations that do not. One participant stated that even though the entire asset would not be transferred, a property interest (a beneficial interest) in the underlying asset can be transferred. Other attorneys indicated that if the participation was correctly written, attorneys could provide the type of opinion required by auditing

standards. The key question of whether there has been a transfer must be discussed further with the Board.

## **5. What Are the Powers of the FDIC in Receivership?**

An FDIC attorney indicated that the FDIC recognizes participations as sales as long as a true sale analysis is performed. He also stated that the FDIC's practice as a receiver is to sell in bulk rather than exercise setoff rights or otherwise attend to individual loans. If there is a setoff against an asset that has been sold, the FDIC will make up the amount that was set off dollar for dollar to the buyer and often provides reps and warranties to that effect.

The FDIC attorney also indicated that the issue of setoff is hypothetical. He stated that virtually all of the FDIC's experience with receivership came from the bank failures in the 1980s; 90 percent of which came about subsequent to the Penn Square Bank failure in 1982. Since 1983, approximately 2800 banks have failed (including some banks that are not subject to receivership by the FDIC) and the FDIC staff could not identify a single instance where a setoff reduced a participant's share. The Chief Counsel for the FDIC indicated that one could hypothesize situations in which the FDIC would be bound to require setoff if a bank failed due to its requirement to act in the lowest-cost manner possible; however, the FDIC has not to date encountered that situation.

### **Follow-up Items:**

Seth Grosshandler, a participant representing the Loan Syndication Trade Association (LSTA), stated that the LSTA will prepare a supplemental submission on why they believe participations can be sales and send its analysis to the Board. Follow up with Mr. Grosshandler on this matter is required.

The distinction between "good" and "bad" participations should be further discussed at the June 17, 2004 roundtable.

### **General Announcements:**

None.

**QSPE Roundtable  
May 25, 2004  
9:00 a.m.–12:00 noon**

<b>Participants</b>	<b>Affiliation/Representing</b>	<b>Letter Number</b>
Mark Ellenberg	American Bar Association	7
Fred Feldkamp	Fred Feldkamp	5
Seth Grosshandler	Loan Syndication and Trading Association	14
Robert Hugi	American Securitization Forum	20
William F. Kroener III	OCC, FRB, FDIC, OTS, AND NCUA	25
Harriette Resnick	J.P. Morgan Chase & Co.	19
Cindy Williams	Commercial Mortgage Securities Association	18

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Robert H. Herz	FASB Chairman
George J. Batavick	FASB Board
Gary S. Schieneman	FASB Board
Leslie F. Seidman	FASB Board
Edward W. Trott	FASB Board
Katherine Schipper	FASB Board
Jim Leisenring	IASB Board
Lawrence W. Smith	FASB Director of Technical Application & Implementation Activities
Patricia A. Donoghue	FASB Project Manager
Ron Lott	FASB Senior Technical Advisor
Victoria A. Lusniak	FASB Staff
Joshua G. Gagon	FASB Staff