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## <u>MEMORANDUM</u>

May 10, 2004

To: Director

Financial Accounting Standards Board

ce: Commercial Finance Association

From: Otterbourg, Steindler, Houston & Rosen, P.C.

Goldberg, Kohn, Bell, Black, Rosenbloom & Moritz, Ltd. General Counsel to Commercial Finance Association

Re: FASB Statement No. 140: Setoff and Isolation

Our firms are general counsel to the Commercial Finance Association. The Commercial Finance Association is the global trade association for domestic and international banks and other financial institutions that provide asset-based lending, commercial financing and factoring to corporate borrowers. Among the approximately 230 members of the CFA are substantially all of the major money center banks and regional banks, as well as other large and small commercial lenders in the United States. Nationally, secured financing provided by CFA members presently exceeds \$325 billion in outstanding loans and in terms of revolving and other advances by the CFA members under credit agreements, exceeds \$2 trillion per year. More information concerning the CFA may be found at its website at www.cfa.com.

We are responding to the FASB staff request for information dated April 9, 2004, concerning the implications of certain rights of setoff for the accounting treatment of loan participations and on other arrangements under FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.

- 1. <u>Characteristics of Loan Participations</u>. In considering the effect of the common law right of setoff on the "isolation" of the assets of the "originating bank" with respect to an interest in a loan sold by such originating bank pursuant to a participation under FASB Statement No. 140, it is critical to understand certain elements of typical participation arrangements between lending institutions.
- (a) The originating bank, or as it is customarily referred to, the "lead lender", is the seller of an "undivided fractional interest" in (i) the amounts owing to the lead lender from the borrower, (ii) the rights of the lead lender against the borrower, (iii) any payments received from or on behalf of the borrower and (iv) any collateral that secures the obligations of the borrower to the lead lender.

- (b) Under the terms of participation arrangements, the lead lender agrees to act as agent on behalf of the participant in servicing and administering the loan arrangements with the borrower.
- (c) The lead lender agrees to hold any payments received by the lead lender in respect of the obligations of the borrower (regardless of the source of such payments) for the benefit of the participating lender based on the participating lender's fractional interest in the debt owing from the borrower, including agreeing to hold such funds in trust for the participating lender.
- (d) The lead lender has no obligation to make any payments to the participating lender in respect of the purchase price paid for the participation interest by the participating lender, but is only obligated to remit payments that the lead lender receives from or for the benefit of the borrower, whether from collections of receivable collateral or the realization on any other collateral or from any other source. The participation interest is sold by the lead lender to the participant on a "non-recourse" basis without any personal liability for payments by the lead lender to the participant.
- 2. <u>Isolation of Assets</u>. The question raised by the request for information is whether the nature of the rights of the lead lender (and the parallel rights of the borrower) to set off against funds of the borrower held by the lead lender, or that the lead lender is obligated to pay to the borrower, should affect the treatment under FASB 140 of the transfer to a participating lender of a participation interest in loans by the lead lender to the borrower. In our view, based on the characteristics of the participation arrangements described above, there does not seem to be any basis for changing the established treatment of such arrangements as a sale by the lead lender to the participant. The exercise of the right of setoff and its consequences might be analyzed as follows:
- (a) First, the question is whether the lead lender is entitled to set off for the entire amount of the debt owing by the borrower or only the fractional interest in the undivided debt that the lead lender may have retained for its own account.
- (i) The answer hinges on the element of mutuality between the parties. The element of mutuality between the parties involved in the setoff to the full extent of the debt owing by the borrower is maintained because the debt is owed by the borrower to the lead lender, not the participating lender. The borrower does not have any express contractual duty to the participant. Its only obligations are to the lead lender. Consequently, the lead lender may set off for the full amount of the debt, including the portion in which the participating lender has an undivided fractional interest.
- (ii) The right of the lead lender to payment of the entire amount of the debt owing to it (including any portion in which it has sold an undivided fractional interest) is consistent with the treatment of the claim of a lead lender in the bankruptcy of a borrower. In bankruptcy, the lead lender has the right to file its claim for the entire amount of the debt, and in fact, is the only party that has such right.
- (b) Second, given the right of the lead lender to set off against assets of the borrower held by the lead lender (or owing by the lead lender to the borrower, as the case may be) for the

- entire amount of the debt owing by the borrower (regardless of any sales by the lead lender of undivided fractional interests in the debt), the question becomes who receives the benefit of the setoff.
- (i) If the lead lender were entitled to the entire amount of the benefits of such setoff, then there might be the basis for the argument that the "assets" of the transferor were not "isolated". However, the terms of the arrangements between the lead lender and the participating lender provide that upon the receipt of any payment in respect of the debt, the participating lender is entitled to its share of such payment based on its fractional interest in the debt. The setoff against the funds held by the lead lender effectively constitutes a payment in respect of the debt, whether the funds are held separately as cash collateral or the funds represent amounts payable by the lead lender to the borrower as a depository bank obligated to make payment to its depositor.
- (ii) Under the terms of the arrangements with the participating lender, the lead lender is obligated to remit to the participating lender the participating lender's fractional interest in such payment, regardless of how it arises. The funds (or the "receivable" of the borrower due from the depository bank) constitute assets held in trust by the lead lender for the benefit of its participants in the debt. Such assets are the functional equivalent of any other form of collateral given by the borrower to the lead lender, which then holds its interest in the collateral for itself and the benefit of its participating lenders. The fact that the lead lender has an interest in such funds in its capacity as lead lender and agent for the participant is no different in the context of the sale of an undivided fractional interest in the debt than in the sale of a portion of the debt itself where the lead lender is an "agent" for a syndicate of lenders.
- (iii) As a result, upon the insolvency of the lead lender, the creditors of the lead lender are not entitled to the benefit of the "asset", whether cash collateral or the "receivable" due to the borrower, to the extent of the interest of the participating lender in such asset. Such assets are not available generally for the creditors of the lead lender, since the lead lender does not have an interest in them, other than in its role as agent and servicer on behalf of the participating lender. Any payments received by the lead lender from such assets are held by the lead lender as agent and "in trust" for the benefit of the participating lender. The assets of the borrower that are the source of repayment of the debt belong to the participating lender to the extent of its fractional interest. The intent of the participation arrangement is that the applicable share of the payments received by the lead lender from the borrower or its assets, whether pursuant to setoff or otherwise, would not be available to the creditors of the lead lender, but would in fact be excluded from the "estate" (or equivalent) of the lead lender and only available for satisfaction of the participation interest of the participating lender.
- 3. <u>Absence of Recourse as Governing Principle</u>. The fundamental character of the relationship between the lead lender and the participating lender is that it is without recourse by the participant to the lead lender. Therefore, the transaction between the lead lender and participating lender should be treated as a sale for accounting purposes.
- (a) The issue of whether the transfer of a participation interest is treated as a sale should be determined by whether there is recourse by the participant to the lead lender (i.e. whether the economic benefit and burdens have passed to the participant pursuant to the

- purchase of the participation), so that the lead lender has only undertaken duties functionally as a servicer without any obligation to repay the interest of the participant in the loan other than from the payments from the underlying the borrower. The question of the existence of a true sale should not be determined by the presence or absence of a particular remedy of the lender as against the borrower, such as the right of setoff.
- (i) For example, the realization on the deposit of the borrower by the lead lender pursuant to a right of setoff might just as easily be characterized as the exercise by the lead lender of its rights as a secured party in the deposit account. Or, for that matter if the lead lender were to exercise a remedy to foreclose on inventory collateral or notify account debtors to collect on receivables collateral, the exercise of such a right should not change the characterization of the transaction between the lead lender and the participant. Neither should the existence of the right of setoff.
- (ii) The characterization as a true sale should not depend on whether there is any collateral, whether in the form of a deposit account maintained by the borrower at the lead lender (who is functioning as an agent or custodian for purposes of perfection) or in the form of any other property of the borrower.
- (b) At the same time, under the terms of a typical participation arrangement, the lead lender has no personal liability to the participant. The participant's risk is not based on the credit of the lead lender in any respect or any obligation of the lead lender to the participant. The source of funds for the payment by the lead lender to the participating lender is not from the lead lender's own funds, but from the funds that the lead lender has received from or on behalf of the borrower or its assets. Since the participating lender does not have any recourse to the lead lender to obtain payment of its participation interest, under FASB Statement No. 140 the transaction should be treated as a sale.
- 4. Industry Practice Should Govern. It is the understanding in the financial industry that the sale of a participation interest in debt owing from a borrower is a "sale" of such an interest and not a security interest. The legal analysis of the rights associated with participations as described above has consistently been the basis for the treatment of participations among financial institutions. The accounting treatment, both in the records of the lead lender as the seller of the participation interest and the participant as the purchaser of the participation interest, has customarily been as a purchase and sale. Ultimately, the treatment of participations as described above has been widely accepted and has not had any adverse affect on any of the parties involved or other constituencies. To attempt to change the common understanding of the relationship between lead lender and participating lender would cause significant upheaval within the industry.
- 5. Accounting Treatment Should be Consistent with Revised Article 9. Participations were considered in the revisions to Article 9 of the Uniform Commercial Code that have become effective in all 50 States. Revised Article 9 was drafted to provide for the transfer of participation interests to be treated as sales and purchases of an interest in the debt.
- (a) Participations are generally considered to fall within the definition of the category of assets referred to as "payment intangibles" in Revised Article 9. Sales of such payment

- intangibles are generally treated similarly to sales of "accounts" within Revised Article 9. However, Revised Article 9 goes even further with sales of loan participations.
- (b) The term "security interest" in Revised Article 9 (as in former Article 9) is defined to include, among other things, two distinct types of transactions: (i) an interest in property that secures payment of an obligation, which is perhaps the more common understanding of the term and (ii) an interest of a buyer of a payment intangible (or account, chattel paper, etc.), including a buyer of a loan participation. Revised Article 9 was expressly drafted to avoid the need for a buyer of a loan participation to file a financing statement by providing for the automatic perfection of the type of "security interest" that arises upon the sale of a payment intangible, under Revised Section 9-309((3), as opposed to when a "security interest" is given to secure an obligation.
- (c) As a matter of policy, FASB should not adopt a rule that is inconsistent with the law as in effect in all 50 States by not allowing for the sale of participations under accounting rules.
- 6. Accounting Treatment Should Be Consistent with Regulatory Treatment. Financial institutions use participations to satisfy the requirements of various federal regulations to limit the exposure of such institution to a single borrower. The federal regulations recognize that participations are an acceptable means for limiting such exposure because the risk of the repayment of the underlying debt due from the borrower is effectively shifted to the institution that has purchased the participation to the extent of its undivided fractional interest. To treat the participation other than as a sale is inconsistent with the regulatory regime applicable to many lenders. Any change to the accounting rules should be avoided so as to prevent a conflict in the legal consequences for financial institutions for participations under applicable regulations.
- 7. Party Autonomy: Expectation of the Parties Should be Respected. Under a typical participation agreement, the originating bank as the "seller" of the undivided fractional interest in the debt and the participating lender, as the purchaser of such interest, expressly state that their expectation is that the transaction is a sale. Such treatment has become the custom and the practice and is the expectation of financial institutions that use participations to manage risks in their portfolios. To change the accounting treatment of participations would undermine the expectations and intent of the parties. Clearly, this is an instance where the principle of party autonomy should be respected. Given the theoretical underpinnings of the arrangements described above, the express intent of the parties should be respected and the transaction treated under accounting principles in accordance with such expectations.