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May 10, 2004

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Letter of Comment No: /1
File Reference: 1200-SRI
Date Received: </ri>

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Rc: Setoff and Isolation

Ladies and Gentlemen:

This response addresses questions 2 and 4 of the FASB Staff's April 9, 2004 Request for Information. This response is not intended to be a complete discussion of the legal issues raised by these two questions; rather, we wish to bring to your attention several discrete issues that we believe are important for FASB to consider in its deliberations.

Question 2 asks: "How are rights of setoff currently considered in true sale analyses performed by attorneys? If they are not considered, why not?" We conclude, unequivocally, that the existence of setoff rights is generally not a factor that affects, or should affect, true sale analysis.

FASB's concern about setoff rights may reflect possible confusion between transferring rights and valuing rights. Under law, with only one unique exception, ¹ an entity can transfer only those rights it owns. This universally-recognized principle goes back to Roman law, and is often referred to as nemo dat quod non habet – or one who has not cannot give.²

Applying this principle to the sale of receivables, or indeed any other asset, an entity can transfer only the rights it owns in receivables (or other assets). Therefore, to the extent the transferor's rights in receivables (or such other assets) are limited, such as by setoff rights or

¹ This unique exception is that "holders in due course" of "negotiable instruments," under Uniform Commercial Code (UCC) § 3-302, sometimes are not subject to defenses and encumbrances to which the transferor is subject. UCC § 3-305. The exception's rationale is that where negotiable instruments are used in lieu of cash, they should be as freely transferable as cash.

Steven L. Schwarcz, Intermediary Risk in a Global Economy, 50 DUKE LAW JOURNAL 1541, 1573 (2001).

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other defenses of the obligor of (or third-party claims against) the receivables, the transferor can only transfer those rights as so limited.

True sale opinions address, and indeed should address, solely whether the transfer has effectively vested the rights of the transferor, as the same may be limited, in the transferce for bankruptcy purposes. If the transfer meets the relevant true-sale criteria of applicable law, it removes those rights from the transferor for bankruptcy purposes. The value of those rights, however, is a very different issue from that of their true sale.

To the extent a transferor's rights in receivables are limited, the transferor should value those receivables to reflect the limitation. Likewise, the purchase price paid by the transferee for those receivables should reflect their value as diminished by the limitations. Nothing in FAS 140 is inconsistent with these valuations. Furthermore, since the transferor will generally be in a better position than the transferee to ascertain the existence of and evaluate setoff risks, the transferor usually must assume any such risks for which the purchase price is not already discounted.³

The first part of question 4 asks: "Can setoff rights be eliminated, and, if so, how can the elimination be accomplished?" Section 9-404 of the Uniform Commercial Code provides for two methods to restrict or eliminate setoff rights for most types of financial assets that are securitized. In otification to the obligor or a waiver agreement by the obligor. However, notification is only a partial solution, since it serves to eliminate only those setoffs which arise from claims accruing after the notice and which are unrelated to the transaction that gave rise to the underlying financial asset.

In order to fully eliminate setoff claims, regardless of the date they accrue, and regardless of whether they are related to the transaction that gave rise to the financial asset, an enforceable agreement of the obligor is required. Some types of financial assets, such as commercial credit agreements and commercial equipment leases, may contain waiver of setoff provisions (although they may not be broad enough to eliminate all setoff rights). However, waiver agreements would not work for one of the most common forms of securitized assets -- trade receivables -- because they are almost never represented by contracts that contain waiver of setoff provisions. Trade receivables are commonly represented by invoices which contain only a description of the goods to be sold and the price and payment and shipping terms, and in any event the invoices are not signed by the obligor. Furthermore, because of the short-term nature of trade receivables, securitizations of trade receivables are not done on a fixed pool basis. As a result, numerous new

³ George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 488-89, 496-500 (1970) (arguing that it is up to the seller to achieve a solution, such as offering guaranties, to the problem of quality uncertainty).

⁴ Section 9-404 applies to payment rights consisting of accounts, chattel paper and general intangibles but does not apply to negotiable instruments.

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obligors are constantly being added, and it would be an immensely costly and time-consuming endeavor to try to obtain waivers from a constantly changing pool that may consist of thousands of obligors. It is also likely to be a futile effort, because it is not customary practice for an obligor to waive claims (e.g. for defective goods) relating to goods which have not yet been shipped.

We hope that FASB will not adopt a blanket rule that requires setoff waivers, knowing that it is contrary to industry standards and cannot be complied with by a significant segment of securitization transferors. Indeed, we see no reason why such a rule would be needed, since the answer to FASB's question 2 shows that the existence of setoff rights does not, and should not, impact true-sale characterization.

Very truly yours,

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