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AMERICAN BAR ASSOCIATION

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Section of Business Law 750 North Lake Shore Drive Chicago, Illinois 60611 (312) 988-5588 FAX: (312) 988-5578 e-mail: businesslaw@abanet.org website: www.abanet.org/buslaw

CHAIR Steven O. Welse 801 South Figueros Street 40° Floor Loe Angeles, CA 90017-5758

ASSOCIATION YEAR 2003-2004

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BUDGET OFFICER

MMEDIATE PAST CHAIR

TA&I Director -- Setoff & Isolation 401 Merrit 7

Norwalk, CT 06856

onsin Ave., NA

P.O. Box 5116

Re: Setoff & Isolation

rd M. Phillips Francisco, CA Dear Sir:

ard H. Gilbert Tampa, Ft.

John M. Littin

This letter is submitted on behalf of the Section of Business Law of the American Bar Association in response to the FASB Staff's request for information, dated April 9, 2004. The views expressed herein are presented on behalf of the Section of Business Law (the "Section"). These comments, which have been prepared by members of the Section's Committee on Developments in Business Financing and Committee on Commercial Financial Services, represent the views of these Committees only and have not been approved by the American Bar Association's House of Delegates or Board of Governors and therefore do not represent the official position of the ABA.

William H. Schorling

Marsha E. Simme New York, NY e W. Tross

Yvonne Walker Palo Ato, CA

James L. Baillie Sinnescolle, MN land E. Brandel iel L Doliner

Lynn A. Howell St. Petersburg, FL

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The Section has a significant interest in the Board's action on the subject of isolation. This interest exists at many levels, but this letter focuses primarily on two. First, the accounting profession, in certain circumstances, refers to legal opinions when determining how to reflect certain transactions on financial statements. It is important to both those who will prepare and those who will receive these opinions that the opinions, and their limitations, are correctly understood. In particular, we wish to stress that opinions can be written only with respect to legal concepts - and "legal isolation", as used in FASB 140, is not a legal concept. Second, attorneys are regularly involved in the structuring and documentation of transactions involving the transfer of financial assets. It is important to attorneys advising clients with respect to such transfers that the applicable accounting rules (1) be clear and (2) not be so onerous as to disrupt what is, at the moment, an efficient and vibrant market.

The Section will not burden FASB with duplicative or cumulative comments. We are aware that other organizations are drafting more detailed responses. The goal of this letter is to emphasize certain broad issues of particular importance to Section members encompassed by the FASB request for information.

1. Is the information about setoff rights in this paper accurate for transferors subject to the U.S. Bankruptcy Code as well as for transferors subject to receivership by the FDIC or other regulatory agencies?

Answer: Generally, the information is correct. However, the information is best understood in proper context.

Setoff rights are creditor specific. The fact that one creditor could assert a defense of setoff to a debt it owes to the debtor does not mean that other creditors of the debtor will have similar or any setoff rights. In this regard, setoff is fundamentally different from recharacterization of a sale as a financing or from the exercise of a call by a transferor.

While the Bankruptcy Code and FIRREA preserve setoff rights for both creditors and the debtor, setoff is seldom, if ever, good for the debtor. Setoff permits a creditor effectively to be paid in full, while other creditors of the same priority are paid only a pro rata share of the remaining assets of the estate. Assume that A, the creditor, owes \$100 to B, the debtor, and that B owes \$50 to A. Further assume that B will pay 20% on unsecured claims. A will be able, through setoff, to receive 100% of its \$50 claim against B. An unsecured creditor with a \$50 claim would only receive \$10. Thus, debtors are seldom interested in setting off and usually look for ways to combat setoff. This is true even where the asset giving rise to the debt has been sold or participated out. In the case of a sale or participation, the obligation to the creditor simply would be replaced by an equal obligation to the purchaser of the asset or the participant.

Where an FDIC insured institution is placed in receivership or conservatorship, the FDIC is motivated to setoff against depositors where a loan participation has been sold. This is because the setoff substitutes an unsecured claim by the participant for the insured claim of the depositor. Note that the beneficiary of the setoff, however, is not the seized bank's estate, but the FDIC, as insurer. The setoff has a negative impact on the bank's estate, just as it has on the estate of a Bankruptcy Code debtor.

The Board should note that setoff is not limited to the securitization and participation of financial assets. Setoff defenses could apply with respect to almost any asset transfer. For example, A purchases a business from B, paying in full at closing. The transaction includes a transfer of accounts receivable. Subsequent to the closing, customers might be able to setoff against accounts receivable debts owed to them by B from an unrelated business. As another example, A, an appliance dealer, purchases a refrigerator from B, an appliance manufacturer. A pays for the refrigerator in accordance with normal trade terms. Subsequently, A submits to B a claim for warranty repairs performed on the refrigerator. At the same time, A owes B for a new delivery of refrigerators bought on normal trade terms. A might be able to setoff the warranty claim against the amounts it owes to B for the new delivery.

The Board should also note that all transfers could be affected by other defenses. For example, the purchasers of loans or a business and its receivables could be affected by fraud committed by the seller on an obligor.

2. How are rights of setoff currently considered in true sale analyses performed by attorneys? If they are not considered, why not?

Answer: Setoff rights are taken into account by most attorneys in rendering "true sale" opinions. An opinion letter covers the laws that a lawyer in the jurisdiction whose law is being covered by the opinion letter, exercising customary professional diligence, would reasonably be expected to recognize as being applicable to the entity, transaction, or agreement to which the opinion letter relates. As a general rule, the body of law concerning setoff is considered applicable to true sale analysis and is neither carved out of true sale opinions nor assumed away. Thus, the existence of setoff rights does not alter the conclusion reached in the opinion. Similarly, setoff rights, while considered, do not alter the conclusion that a transferor would not be consolidated with a transferee.

This is illustrated by existing guidance concerning FASB 140. AU Section 9336 (SAS No. 73), states, in relevant part,

.13 An example of the conclusions in a legal opinion for an entity that is subject to the U.S. Bankruptcy Code that provides persuasive evidence, in the absence of contradictory evidence, to support management's assertion that the transferred financial assets have been put presumptively beyond the reach of the entity and its creditors, even in bankruptcy or other receivership, follows:

"We believe (or it is our opinion) that in a properly presented and argued case, as a legal matter, in the event the Seller were to become a Debtor, the transfer of the Financial Assets from the Seller to the Purchaser would be considered to be a sale (or a true sale) of the Financial Assets from the Seller to the Purchaser and not a loan and, accordingly, the Financial Assets and the proceeds thereof transferred to the Purchaser by the Seller in accordance with the Purchase Agreement would not be deemed to be property of the Seller's estate for purposes of (the relevant sections) of the U.S. Bankruptcy Code.....1

The opinion paragraph above is commonly known as a true sale opinion. The opinion expresses two conclusions, that the transfer is a sale and that the transferred assets would not be property of the transferor's estate in the event that the transferor became a debtor under the Bankruptcy Code. Most true sale opinions neither carve out setoff nor assume it away. Thus, the opinions effectively state that setoff would not alter the conclusion.

Sale is a well developed legal principle. It is governed by applicable state law and has been explored in numerous reported decisions. Similarly, property of the estate is a legal principle defined by section 541 of the Bankruptcy Code and explored in numerous reported decisions. In reaching a conclusion that a sale has occurred and that a transferred asset would not be property of a debtor's estate, counsel will consider factors such as the intent of the parties and whether the benefits and burdens of ownership have been shifted

¹ AU 9336 contains a similar requirement for institutions subject to FIRREA.

from the transferor to the transferee. In this regard, credit recourse to the transferor, whether directly or through a put right that permits the transferee to require the transferor to repurchase the transferred assets at par value, might not be consistent with a sale. The put leaves the risks of ownership with the transferor. Similarly, retention by the transferor of a par call right on the transferred assets might not be consistent with a sale, because it leaves the benefits of ownership with the transferor. That is, the call at par permits the transferor to reap any appreciation in the market value of the assets between the time of the sale and the exercise of the call.

Setoff does not represent credit recourse, a put or a call. Credit recourse means that the transferor must pay the transferee when the obligor does not pay. When the obligor invokes a right of setoff, it is paying its obligation in full. The obligor is just using the currency of an offsetting obligation instead of cash. Moreover, the setoff is triggered not by the transferor, but by the obligor. Transferors probably do not have the right to invoke setoff after the asset associated with one of the offsetting debts has been sold. The sale of participations is a possible exception to this rule. In the narrow circumstances where a transferor may be able to exercise a right of setoff against the obligor, the transferor is not exercising a call on the transferred asset in any commonly accepted sense of the word. By exercising setoff, the transferor is simply satisfying its obligation to the obligor and replacing it with an equal obligation to the transferee. The transferee remains in full possession and control of the transferred asset at all times. The transferee could, for example, sell the asset without interference from the bankruptcy court, the transferor, or the transferor's creditors. Similarly, the transferor could not restructure the asset or strip excess value from the asset, as it could if the asset were simply security for a financing by the transferee. Accordingly, setoff rights do not affect the legal conclusion that a sale has occurred.

3. What additional information about setoff rights should the Board consider?

Answer: The Board should consider the treatment of setoff rights in securitization transactions from a credit underwriting point of view. The purpose of structured finance is to enhance the monetization of assets by isolating the assets from extraneous bankruptcy risk. That is, if the assets were simply pledged as security for a loan, the lender would have to consider not only the credit profile of the assets, but the credit risks of the borrower. A borrower bankruptcy could adversely affect the lender by, among other things, interrupting cash flows, staying foreclosure remedies, substituting different collateral for that originally pledged, altering the interest rate on the loan and changing the repayment schedule for the loan. Where a true sale and nonconsolidation opinion between the transferor and transferee can be rendered, the assets are isolated from the transferor's bankruptcy risk. The assets can then be underwritten solely on their own merit. The risk of setoff is, in many instances, inherent in the asset. The rating agencies and investors understand this risk and control for it in structuring the transaction.

How to account for transfers that satisfy the criteria of the rating agencies and investors for isolation from bankruptcy risk is the province of the Board and the accounting profession, not attorneys. As persons who frequently rely on financial statements, however, it seems clear that a financial statement that derecognized assets transferred in circumstances where a true sale and nonconsolidation opinion could be rendered would seem to more fairly

reflect the financial situation of the entity than statements that retained the assets solely because contingent rights of setoff existed. Accordingly, we would encourage the Board to continue its investigation of alternative methods for accounting for setoff rights and other contingent defenses.

4. Can setoff rights be eliminated, and, if so, how can the elimination be accomplished? Are the legal aspects the same for transferors subject to the U.S. Bankruptcy Code as for transferors subject to receivership by the FDIC or other regulatory agencies? If not, what are the differences?

Answer: Setoff rights might be subject to elimination in some instances, but not in others. For purposes of evaluating the elimination of setoff rights, the universe of financial assets can be divided into two subsets: (1) negotiable instruments and (2) everything else. Negotiable instruments are promissory notes with certain legal characteristics, such as real estate mortgage notes. All other financial assets, whether represented by writings or intangible, are not negotiable instruments.

Under the UCC, the purchase of a negotiable instrument in good faith, for value, and without notice of defenses, gives the purchaser "holder in due course" status. A holder in due course generally is not subject to defenses of setoff based on debts owed to the obligor by the transferor. An exception may exist where a negotiable instrument arises out of a consumer transaction. In such cases, federal law may preclude the elimination of defenses, including setoff. A holder in due course is also subject to other defenses good against the transferor, such as infancy, incapacity, illegality, duress and certain types of fraud. Note that, from a legal opinion point of view, holder in due course status depends on certain case-specific inquiries, such as whether or not the holder had notice of a defense. An attorney asked to render an opinion as to whether setoff rights existed would have to make favorable assumptions concerning such facts.

In the case of assets other than negotiable instruments, elimination of obligor setoff rights would depend on either notice to the obligor or an express waiver by the obligor. In cases where notice is effective to cut off setoff rights, it cuts off only rights arising after the transfer. Notice is not effective to cut off recoupment rights, or claims of the obligor arising from the transaction that gave rise to the assigned asset. In cases where waiver is required, the refusal of some obligors to grant waivers would significantly hamper securitization activities. Further, satisfying waiver and notice requirements could, in some instances, be prohibitively expensive. Consumer protection laws may also preclude the elimination of obligor setoff rights for some classes of assets. In general, the area is not well suited to the delivery of legal opinions. We also emphasize that transfer of assets to a special purpose entity or qualifying special purpose entity does not impact setoff rights in any way.

5. The board recently discussed defining isolation of financial assets to mean that the value of those assets to the transferee does not depend on the financial performance of the transferor and is not affected by bankruptcy, receivership, or changes in the creditworthiness of the transferor. Given that definition of isolation, what factors other was transferor than setoff rights are not typically considered by attorneys in rendering true sale opinions that may interfere with isolation of transferred assets from the transferor and

its affiliates (except bankruptcy-remote SPEs)? Please explain why those factors are not considered.

Answer: As noted above, the factors relevant to determinations concerning sale and property of the estate are considered by attorneys rendering true sale opinions. Thus, we cannot identify factors not typically considered by attorneys in rendering true sale opinions that may interfere with isolation of transferred assets.

The isolation standard under consideration by the Board would effectively replace the current standard of "legal isolation" with one of economic isolation. While isolation from bankruptcy risk of the transferor, as indicated by a true sale opinion, would be relevant to value, numerous other factors could affect the value of transferred assets subject to true sale opinions. For example, were a mortgage originator to become a debtor in a case under the Bankruptcy Code, loans originated by it would become less valuable in the secondary market, because the representations and warranties applicable to the loans no longer had any credit behind them, and because the originator's failure raised doubt about the quality of its origination procedures. Similarly, a refrigerator in the hands of an appliance dealer becomes less valuable when the company that made the refrigerator goes out of business. These valuation issues have no impact on a legal sale conclusion.

Finally, it bears repeating that the definition of isolation under consideration is not based on legal principles. Accordingly, attorneys could not render an opinion as to whether this isolation test is met.

We hope the foregoing aids the Board in its deliberations. Members of the Section would be pleased to have representatives participate in further discussions on this topic, including the round-table discussion scheduled for May 25, 2004, or to otherwise be of assistance.

Sincerely,

Steven O. Weise Chair, Section of Business Law

Amy McDaniel Williams
Chair, Committee on Developments in Business Financing

Jeffrey S. Turner Chair, Committee on Commercial Financial Services

Starr L. Tomczak
Chair, Subcommittee on Securitization of Assets of the Developments in Business
Financing Committee

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Martin Fingerhut

Chair, Subcommittee on Securitization and Derivatives of the Commercial Financial Services Committee

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Drafting Committee:

Mark Ellenberg, Chair Thomas Albrecht Edward DeSear Martin Fingerhut Robert Hugi Matthew Joseph Eric Marcus Peter Partee Richard Rudder Bianca Assoys Russo Nancy Schimmel Steven Schwarcz Lisa Sloan Lynn Soukup Starr L. Tomczak