



Letter of Comment No: 20a
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June 14, 2004

TA&I Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: Setoff and Isolation

Ladies and Gentlemen:

The American Securitization Forum¹ is writing to supplement our May 10 letter relating to setoff and legal isolation. Consistent with our initial letter, we do not address participations. This letter has been prepared and reviewed by attorneys active in our Legal, Regulatory, Accounting and Tax Committee. Although we support the positions taken in the comment letters of the Loan Syndications and Trading Association and others relating to participations, our focus is on making sure that FASB understands how its resolution of the setoff issue could affect ordinary, absolute transfers of receivables.

In particular, we are writing to refute the following assertion, which is made repeatedly in the comment letter submitted by Frederick L. Feldkamp:

“Upon a “transfer,” the common law right of a debtor and creditor to offset mutual matured claims is always severed.”

The quoted language appears on p. 4 of Mr. Feldkamp’s letter, and substantially the same assertion is repeated on pages 21, 22 (twice) and 23. The assertion is central to Mr. Feldkamp’s comments and his recommendations as to how FASB should interpret or amend the isolation standard. This assertion is misleading as it relates to setoff rights of debtors/obligors.²

The importance of this point is illustrated by another quote from Mr. Feldkamp’s letter. Again on page 4, Mr. Feldkamp suggests a revision to a portion of the staff request for information to read as follows:

“If common law setoff rights are not eliminated by a purported transfer, the financial asset is not isolated from the transferor as required by Statement 140.”

¹ The American Securitization Forum (the “ASF”) is a broadly-based professional forum of participants in the U.S. securitization market. Among other roles, the ASF members act as issuers, underwriters, dealers, investors, servicers and professional advisors working on securitization transactions. The ASF is an adjunct forum of The Bond Market Association. The views expressed in this letter are based upon input received from a broad range of ASF members including members of the ASF Accounting and Tax Subcommittee. More information about the ASF, its members and activities may be found at its internet website, located at www.americansecuritization.com.

² We do not disagree with the other component of Mr. Feldkamp’s statement, relating to the effect of an absolute transfer on the rights of the transferring creditor.

Our concern is that this may seem to provide FASB with a simple and attractive resolution of the setoff issue. It does not. Many absolute sales of financial assets with no recourse to, or other continuing involvement by, the transferor would fail the test suggested by Mr. Feldkamp, because absolute transfers of non-negotiable assets normally do not eliminate obligor setoff rights, whether common law or otherwise.

Mr. Feldkamp's focus on "common law"³ setoff rights is hard to understand, because the effect of transfers on obligor setoff rights has to a great extent been governed by statutory law and Federal regulations for at least the last several decades. Currently, Section 9-404 of the Uniform Commercial Code (the "UCC") is in effect in all 50 states, and it establishes the legal rule as to the effect of a transfer of most non-negotiable financial assets (except where it is superseded by the FTC rule discussed in our initial letter (the "FTC Rule") or by other consumer protection laws). As discussed at length in our prior letter, Section 9-404 preserves the obligor's setoff rights relating to defenses and claims that arise before the obligor receives notice of the transfer, assuming that the obligor has not waived those defenses and claims. The FTC Rule, which makes it illegal to eliminate some obligor setoff defenses on consumer credit contracts, has been in force since the 1970s and has the force of federal law.

Even under the common law, Mr. Feldkamp's assertion about obligor setoff is wrong. Essentially the same rules set out in Section 9-404 apply under the common law to non-negotiable financial assets that are not covered by Section 9-404.⁴ At the May 25 round table, Mr. Feldkamp raised a question as to whether the widely respected Restatement Second of the Law, which we cite on this point, is correct. Our research shows substantial support for the Restatement. If Mr. Feldkamp believes there is any material authority to the contrary, we request that he be asked to identify it in a public submission to the Board so that affected constituencies can respond in a manner consistent with open due process.

Section 9-404 of the current UCC is a successor to Section 9-318 in the original UCC, which was substantially identical to Section 9-404 on preservation of obligor setoff rights. Section 9-318 was adopted by all of the U.S. states by 1967 – excluding Louisiana, which was slow to adopt the UCC because of the strong traditional influence of French civil law in that state. Eventually, however, even Louisiana adopted Section 9-318, and Section 9-404 is currently in effect there.

In turn, Section 9-318 largely continued prior statutory and common law. The drafters of the UCC included "Official Comments" to the text of the law, somewhat similar to the "background information and basis for conclusions" section that FASB includes in many of its pronouncements. Here is what Official Comment 1 to Section 9-318 says about subsection (1) of that Section, which contained the text currently under discussion:

"Subsection (1) makes no substantial change in prior law. An assignee has traditionally been subject to defenses or setoffs existing before an account debtor is notified of the assignment."

³ "Common Law" generally refers to the law developed by courts through decisions on particular cases, but it can also include "the law that has grown from the application by the courts of statutes that were generally enacted and were in force for many years." Wolkin, *Restatements of the Law: Origin, Preparation, Availability*, 21 Ohio B.A. Report 663 (1940).

⁴ See American Law Institute, *Restatement of the Law Second, Contracts 2d* §336 (1979).

As discussed at the May 25 round table, the Restatement Second of the Law similarly indicates that the rules set out currently in Section 9-404 and previously in Section 9-318 are traditional common law rules.⁵ Legal practitioners rarely find it necessary to second guess the Restatement or the Official Comments to the UCC on points like this. In fact, courts often cite the Restatement as the basis for legal points that are relevant to their decisions. However, out of an abundance of caution, we have reviewed the case law in New York and Illinois and confirmed what the Restatement and the Official Comment say.⁶

While the law is often not as clear as FASB or others might wish it to be, that is not the case here. Under current U.S. law, obligor rights of setoff frequently survive an absolute transfer. That is the law that FASB and preparers and users of financial statements have to confront. Mr. Feldkamp seems to suggest that there was some "golden age" of common law where that was not true. Widely respected and followed legal sources contradict his position. Even if there was such a golden age in some part of the U.S. or the world, that is irrelevant to the decisions that FASB must now make.

We understand that subsequent to the round table, Mr. Feldkamp also may have "advised the FASB and its staff" regarding Section 553 of the Bankruptcy Code and its effect on setoff rights. In case that advice addressed obligor setoff rights, we will also address the impact of Section 553 on those rights.

The Bankruptcy Code does not create special setoff rights beyond those which exist under non-bankruptcy law. Instead, it imposes restrictions on the exercise of setoff rights by creditors of an entity that is the subject of a bankruptcy proceeding (referred to in the Bankruptcy Code as a "debtor"). For instance, any exercise by a creditor of a setoff right that survives in bankruptcy is subject to the automatic stay. Subject to that and some other requirements and exceptions not relevant here, Section 553 states that "this title [i.e., the Bankruptcy Code] does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case"

We understand that, in the context of *transferor* setoff rights, Mr. Feldkamp's advice to FASB may have stressed the "mutual debt" requirement in Section 553 (as quoted above). We do not know the details of that advice and cannot comment on it. However, FASB should not attach much importance to the Section 553 mutual debt requirement in the context of *obligor* setoff rights against a transferee, which are the subject of this letter. As detailed below, Section 553

⁵ Ibid. Among other authorities, the Restatement cites a decision in which the Supreme Court of Wyoming stated: "But we understand the rule at common law to have been that the assignee of a non-negotiable cause of action took it subject to any equities existing between the assignor and the debtor up to the time that the latter had notice of the assignment, and that this included the right of set-off." Peters & Co. v. School Dist. No. 5, Albany County, 37 Wyo. 237, 260 P. 678 (Wyo. 1927).

⁶ Golden v. D.R. Paskie & Co., Inc., 205 App. Div. 610, 200 N.Y.S. 123 (1923); Hibernian Banking Ass'n v. City of Chicago, 178 Ill. App. 138 (1st Dist. 1913). Pre-UCC law in Alabama was similar. One early case reads as follows: "Ordinarily, an assignee acquires the same rights, no greater and no less, than those possessed by the assignor, and which, by the assignment, the latter has conveyed to the former. In fact, it is generally held that the assignee simply steps into the shoes of the assignor." Upchurch v. West, 234 Ala. 604, 176 So. 186 (1937).

provides little – if any – protection to a transferee against obligor setoff rights that survive the transfer of a receivable.

1. To begin with the obvious, Section 553 only applies in a proceeding under the Bankruptcy Code, which is emphatically not the only context where setoff can be asserted. A transferee seeking to enforce a transferred receivable by a normal collection suit outside of bankruptcy is subject to any obligor setoff rights that are preserved by Section 9-404, the FTC Rule and other similar laws.
2. In addition, Section 553 would not apply in an FDIC receivership or conservatorship.
3. Even in the bankruptcy context, Section 553 provides little or no protection to a transferee against obligor setoff rights. Here the analysis varies depending upon who is in bankruptcy, though the result is generally the same.
 - a. Given FASB's concern about the impact of a transferor's actions and condition after a transfer, a key point is that in a bankruptcy of the transferor, Section 553 is of no help to the transferee. The transferor's bankruptcy would have no effect on the obligor's right to setoff transferor liabilities against the amount that the obligor owes to the transferee under the transferred receivable.⁷
 - b. Section 553 also will not help the transferee if the obligor is in bankruptcy. Section 553 is asymmetrical. It limits the right of a creditor (which would here be the transferee) to offset debts owing to the debtor (here the obligor). It does not similarly limit the right of the debtor (obligor) to take full advantage of any setoff rights available to it under non-bankruptcy law.⁸
 - c. Finally, if the transferee were in bankruptcy, the question arises whether the mutual debt requirement in Section 553 would prevent the obligor from setting off any claim it may have against the transferor against the amount it owes to the transferee's bankruptcy estate under the transferred receivable. We have found only one court decision that deals specifically with this question. The court in the Defense Services case (cited in footnote 7), held that the obligor on the assigned receivable could satisfy the mutual debt requirement because the transferee (referred to by the court as an assignee) had no better rights than its transferor

⁷ This is clear from the plain language of Section 553, which only protects the party that is in bankruptcy. The courts in Defense Services v. United States (In re Defense Services), 104 B.R. 481 (Bankr. S.D. Fla. 1989) and IRS v. Offord Fin. (In re Medina), 205 B.R. 216 (B.A.P. 9th Cir. 1996) reached the same conclusion, on the basis that the transferee effectively stands in the shoes of the transferor for purposes of satisfying the mutuality requirement. A contrary conclusion was reached in In re Fairfield Plantation, Inc., 147 B.R. 946, (Bankr. E.D. Ark. 1992), but we consider that decision to be inconsistent with the plain language of Section 553. Also, In re Medina was decided by the Bankruptcy Appellate Panel of the Ninth Circuit, a higher court than the bankruptcy court that decided In re Fairfield Plantation.

⁸ See In re Bastyr & Assoc., 81 B.R. 978 (Bkrcty. D. Minn. 1988); In re PSA, 277 B.R. 51 (Bkrcty. D. Del. 2002).

(assignor): "Since when does an assignee of a claim wind up with more than the assignor would be entitled to had he not assigned the claim?"⁹

Both inside and outside of bankruptcy, it simply is not true that an absolute transfer always severs obligor setoff rights. This is the legal reality that FASB must confront in resolving the setoff issue. We hope that FASB will reach a resolution that recognizes the legitimate bases for the general legal and commercial views that sales of financial assets can occur notwithstanding the survival of obligor setoff rights.

* * *

The ASF appreciates the opportunity to provide the foregoing comments. We look forward to participating, through attorney members, in the second roundtable discussion. Should you have any questions or desire any clarification concerning the matters addressed in this letter, please do not hesitate to contact George Miller, Managing Staff Advisor of the ASF, at 646.637.9216.

Sincerely,

/s/ Vernon H.C. Wright

Vernon H.C. Wright
Chairman
American Securitization Forum

cc: Frederick L. Feldkamp

⁹ 104 B.R. at 484. In the Defense Services case, both the transferor and the transferee (related entities) were in bankruptcy, and there was fraud in the transaction which the court gave as an additional and independent reason for its decision. However, the court stated that the general principle that an assignee acquires no better rights than its assignor was "dispositive" and that as a result of that principle there was "complete mutuality" between the obligor and the transferee. 104 B.R. at 485. The court in Fairfield Plantation (cited above) did not follow the Defense Services decision on this point, and relied upon the lack of fraud in Fairfield Plantation as part of its rationale. However, the court in Defense Services was clear that its decision did not depend upon the fraud in the transaction, and in In re Medina (cited above) the Bankruptcy Appellate Panel of the Ninth Circuit followed the Defense Services approach in a case that did not involve fraud (where only the transferor, and not the transferee, was in bankruptcy).