

Letter of Comment No: 5a
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Subject: FW: ASF Submission for June 17th Roundtable

-----Original Message-----

From: Feldkamp, Frederick L. [mailto:FFeldkamp@foley.com]

Sent: Monday, June 14, 2004 6:52 PM

To: Director - FASB

Cc: Miller, George; Seth GROSSHANDLER

Subject: RE: ASF Submission for June 17th Roundtable on Setoff/Legal Isolation under FAS 140

The ASF's supplemental letter of June 14 is misleading because it ignores the issue before FASB. The question is whether a participant is a "transferee" and what rights does an asset owner have that indicate it is, or is not, a real "transferee" of the underlying asset.

As with all debates under SFAS 125 and 140, the issue is where does the FASB erect the "snow fence" for when assets and associated liabilities must be reported and when they must be de-recognized?

My letter recited what judges have said in cases, what rulemakers have said in regulations and what Congress and various states have said in legislation. Where no case law exists (as with regard to the rights of depositors under the "depositor preference" rules of FIRREA and the implications of "assignment" language in the new UCC and the FDIC's sale rule), interpretations of law must be extrapolated. Reasonable legal minds can (and will) disagree on those points. The ASF, however, should at least stay on the point of the debate, for the sake of markets.

The rights of obligors against actual transferees of financial assets are not, and never have been, in question during this debate. Yet, that's all the ASF letter discusses. Those rights which ASF debates "run with the assets" on transfer and are, in fact, indicators of a "transfer" which support sale treatment. It's the fact that "participants" lack those rights of "transferees" of underlying assets which brings "sale" treatment for participations into question. **Transferees obtain setoff rights, participants do not.**

Let's not destroy the world of securitization by suggesting that rights of real transferees are inadequate in an effort to save a vestigial "non-transfer" transaction which was invented to circumvent legal restraints on banks that were abandoned decades ago. As the FDIC has said, everyone knows a participation is a debt of the lead bank (not a "transfer" of underlying assets). The supervisors' letter of May 14, 2004, said that about 5 different ways.

The Cleary memorandum filed today does a rather good job of outlining rights of participants and what would be needed to be able to say that a participant had the rights of a transferee. It emphasizes issues which I support, but not all of the issues which I find persuasive.

If there is an actual assignment of the underlying asset, regardless of form, which rises to a level where lawyers can say, with "would" certainty, that the underlying asset is transferred, then we would all agree that sale treatment is appropriate. The cases on setoff in participations are not confusing. All of them say that the rights of "transferees" to setoff do not exist unless a "transfer" occurs and, conversely, where no "transfer" occurs, setoff remains a

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right of the lead lender **because it has not transferred the underlying asset.**

— The question before FASB is whether a participation "transfers" the underlying asset so as to qualify as a "sale" for GAAP. In this debate, it is the rights that are "retained" by an asset owner when it does not, in fact, transfer the underlying asset that are important. By focusing on rights that obligors have against transferees AFTER a transfer, ASF creates needless confusion that only harms markets.

All the current FDIA cases on deposits (and Section 553 of the Bankruptcy Code) say setoff is a right ONLY between the obligor and the asset owner. Therefore, it is altogether appropriate for FASB to say that a "transfer" has not occurred if the transferor retains that right of setoff. Moreover, setoff is NOT a minor issue. In the case of banks, many of their commercial deposits are generated by the banks' commercial borrowers (they are the ones most likely to leave deposits at a bank as it approaches insolvency--as occurred with Penn Square).

As a test of whether a "transfer" occurs, the existence of setoff against the transferor is a very good indicator that no "transfer" has occurred, and it solves what would otherwise be an enormous hole in GAAP. ASF's letter seems to suggest that FASB must allow this "hole" or it will "kill" legitimate transfers. That is simply not the case.

— Setoff is only the most obvious indication that no "transfer" occurs by a participation. Because there is no "transfer," cases have also held that the lead bank is entitled to ignore directions of participants regarding amendment or restructuring of the underlying asset. This is the logical consequence of the many cases holding that a participation is ONLY a contract between the lead and the participant and that the lead bank is NOT a fiduciary for the participant under the participation agreement.

The Cleary memorandum correctly focuses on whether some form of fiduciary relationship is created in deciding whether a "sale" occurs. What it takes to do that remains a matter of debate, however.

An "interest" is certainly granted to the participant, and lawyers can certainly say that "interest" has been "truly" sold to the participant, but that's not the issue. If it was, the "grant of a security interest" would be a GAAP sale.

When one adds the effects of Section 363(h) of the Bankruptcy Code to the Cleary analysis of distinctions between a participation and a non-recourse secured loan, it becomes clear that there are no real legal distinctions. There may be no technical "right of redemption" in the case of a participation, but the bankruptcy court can sell the asset in circumstances where the estate's interest must be protected. That creates an equivalent right. Since bankruptcy courts are courts of equity, moreover, it is straining to say that the lead lender has no "equitable redemption right." In the case of FDIC, it regularly does sell participated assets after receivership, ignoring rights of participants to restrain that.

Thus, the lead has no technical redemption right because it needs none, it retained full control of the asset and cannot be forced to sell it even after default.

— The Cleary analysis does not cite cases where rights of depositors over participants were tested under the "depositor preference" rule of FIRREA. That's appropriate, because there has not, to my knowledge, been a post FIRREA test case.

It is that new rule which caused me to question the ability of participants (that lack a clear

"transfer" or filed security interest) to prevail in future FDIC receiverships. FIRREA brings into question the result of pre-FIRREA cases cited by Cleary for the ability of participants to prevail absent setoff issues. FDIC has said that uninsured depositors could challenge participants and seek to subordinate them even if FDIC waived its priority right.

Without cases, however, that's a debate which will not be resolved for a while. It is the sum total of rights which transferees have but participants do not that are the indications that no "transfer" occurs in either a participation or in the case of a non-recourse secured loan.

With those additional rights, it becomes very clear to me that participations are not equivalent to asset sales.

What happens to markets if FASB says no "transfer" is required to effect a GAAP sale? Simply stated, Enron would look foolish for having spent so much legal effort to create SPEs. All it would have had to do was "declare" that it would "share" assets with investors and neither the asset nor the claims against it would have been disclosed (the same effect as gained by the SPEs).

Imagine what that means for markets. If loans are "shared," assets and claims against them are excluded, just as in Enron. While bank participations are required to be non-recourse for regulatory purposes, there is nothing in GAAP to prevent recourse participations (the shield against recourse arises by the terms of QSPE rules). Thus, all sorts of disguised lending could simply be hidden from investors.

How can that result help to reduce the overall cost of market transactions? It is the rights of shareholders to know what leverage an institution has incurred and the rights of participants to have their transactions reflected accurately that FASB must consider. History shows that protecting those interests is the best course of action for everyone.

Notwithstanding the ASF's comments, I've applied Section 553 of the Bankruptcy Code correctly. When an entity is in bankruptcy, tri-party setoffs are not allowed.

If there is a "transfer," what the ASF's supplemental letter labels as an "obligor" setoff is assertable only against the "transferee" in the event of its bankruptcy, and not against a "transferor" in the event of its bankruptcy. That occurs by virtue of the mutuality requirement of Section 553. It is that law which prevented the "tri-party" setoff claim that was the subject of the Okura case.

In the case of a participation, there is no "transfer" of the obligor's asset whether one looks at bankruptcy, non-bankruptcy law or the FDIA. The transaction "creates" rights, but it does not "transfer" an asset any more than a security interest would.

The fact that the mutual right of setoff can ONLY be asserted by the obligor or the "lead" lender in the event of bankruptcy or receivership is merely a symptom of this "non-transfer." It is a very important symptom, however, particularly in the case of banks because many of their deposits arise by making loans.

Fred

-----Original Message-----

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