

Letter of Comment No: 78A
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VIA E-MAIL: director@fasb.org

Signed Copy by FAX

Ms. Suzanne Bielstein
Director of Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
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File Reference No. 1082-200

Re: Observations on Comments to the Exposure Draft regarding
Consolidation of Certain Special-Purpose Entities;
Nexus of Accounting and Legal Issues

Dear Ms. Bielstein:

As you may be aware, I submitted a comment letter on the above-referenced Exposure Draft which was logged by your office as Letter of Comment No. 78. I am also shown as a signatory to Letter of Comment No. 15. In the context of the former, I will be participating in the morning session of the Open Roundtable being conducted on Monday, September 30, 2002. I am looking forward to that and hope to have an opportunity to meet you and/or Len Tatore who has been my contact with the FASB on this matter.

In anticipation of the invitation to participate (which I requested) and then in preparation for that event, I have obtained and reviewed the Letters of Comment through that numbered 134. Having done so, I am struck by the following: (1) the rather large number of written comments submitted, (2) the range of issues covered by them, and (3) the paucity of comment on issues which arise where accounting concepts and legal issues overlap or intersect. I might also note the potential conflict among various positions taken in the Letters of Comment but that is beyond the scope of this letter. Indeed, it is limited to item (3).

As you are aware, years of friction between the legal and accounting disciplines in a similar context ultimately resulted in what amounted to a "treaty" between the American Bar Association and the American Institute of Certified Public Accountants with respect to responses to audit inquiries. There is more than a theoretical risk that accounting provisions similarly arising in the interstices of the disciplines with respect to matters covered in the Exposure Draft without adequate recognition of the significant differences between them would simply start another long period of uncertainty and even tension between the two disciplines. As indicated by the breadth of issues identified in this letter, there is potential for much greater dissonance in this instance than there was with respect to audit inquiries and almost certainly a far more challenging set of analyses required for their resolution.

In that context and in advance of the Roundtable, I would like to bring to your attention certain legal issues which do not appear to have been addressed directly in the Letters of Comment. Those are summarily described in this letter, but the listing of them should not by any means be considered exhaustive.

1. "Equity in Legal Form"

It appears that the Exposure Draft has abandoned the concept of "equity in legal form" although various of the comment letters either assume that it remains intact or postulate that it should. The problem is that the state laws governing formation of legal entities do not generally use the concept of "equity" in statutory provisions or even case law relating to the formation of any such entity. As a result, it is quite difficult and in some cases would be impossible for a lawyer to render an opinion that a recognized component of the "capital" of a legal entity would constitute "equity". Many states do have statutes regarding conversion between legal entities of differing form which actually use the term "equity" and apply it in a fashion that is relatively predictable. Nonetheless, it is my experience in transactions which have been subject to EITF 96-21 that uncertainty and even confusion are inevitably generated by use of the phrase "equity interest in legal form."

If that phrase or the concept contained within it is brought back into the Interpretation before final adoption, or if EITF 96-21 (and particularly Question No. 8 thereof and the response thereto) is not actually nullified as indicated in Section C2, paragraph a, of Appendix C to the Exposure Draft, this would be an appropriate point for the FASB to address that problem. It might actually be resolved by clarification that the condition is met when an element of "capital" satisfying the category of "equity" for accounting purposes is evidenced by an interest separately recognized under state laws governing the formation of the legal entity involved, and/or the organic instruments (specified and authorized thereby) which evidence formation, as being subordinate to all indebtedness and similar obligations of the legal entity. In all likelihood, that rather complicated and even tortured explanation of the use of the phrase "equity interest in legal form" is actually what should have been intended (and maybe even was) when EITF 96-21 was promulgated. Unfortunately, it is not at all clear as to what concept in that phrase the term "legal" is being applied and what is being tested against that standard: the "equity" status of that interest or the form which evidences it.

2. "De facto Agency Relationship"

One of the Letters of Comment¹ states that the notion of a "de facto agency relationship" as used in the Exposure Draft is new. Principles of agency relationship, including what establishes it and the responsibilities that flow from it, are the result of literally centuries of judicial case law and statutory responses thereto. As a fundamental matter, the entire notion of "de facto agency relationship" as used in the Exposure Draft is completely outside of that legal structure. While that term may be useful for theoretical analysis of accounting issues, it would be a significant mistake to assume automatically that disputes as to the meaning and implications of it would result in judicial proceedings upholding the notion as utilized in the Exposure Draft.

1 No. 124, submitted by Ernst & Young.

3. Securities Laws

Various of the Letters of Comment have noted the realistic possibility that the Exposure Draft as written would require consolidation of an SPE even if that were to result in a false or misleading presentation as to the financial condition and results of operation of the entity thus required to consolidate it.² Unless the FASB can sort through the implications of that under various securities laws or provide guidance in the final Interpretation as to how the impacted parties and their advisers sort through them, the Interpretation would either merely create liability where none logically existed previously or force business enterprisers to forego perfectly legal forms of transactions in order to avoid having to resolve inherent conflicts. Among other things, that would have to address such liabilities as those arising under Sections 11, 12 and 17 of the Securities Act of 1933, as amended; those arising under Section 10(b) of the Securities Exchange Act of 1934, as amended, including regulations adopted pursuant thereto; those arising under Section 313 of the Trust Indenture Act of 1939, as amended; those arising under Sections 18, 19, 48 and 61 of the Investment Company Act of 1940, as amended; those arising under previously well-established state securities laws; and those arising under more recent state law provisions relating to preparation of financial statements, many of those adopted in reaction to the press reports and public perceptions regarding recent "accounting scandals."

4. Insolvency Law

Various of the Letters of Comment have made reference to the "bankruptcy remote" status of certain SPEs that are utilized for financing transactions, including those in which such status is critical to a credit rating of debt securities utilized in the transaction.³ Some of those have suggested that such status on its own is evidence that such SPEs would not logically be consolidated by any party or should not be. I might not disagree with that, but the focus of this letter is simply to note that there is an overlap between "consolidation" for financial reporting purposes and "substantive consolidation" for purposes of a long line of insolvency cases.⁴ When that status is key to a credit rating of debt instruments, it is not unusual for the credit rating agency to require delivery of a legal opinion as to non-consolidation for purposes of insolvency. That is not an easy opinion to give and requires detailed examination of the facts surrounding the free-standing nature of the SPE.

Has the FASB addressed the issue of whether the proposed Interpretation would have an inconsistent application as between the concept of consolidation for financial reporting purposes and the concept of substantive consolidation? Has the FASB considered the possibility that application of the Exposure Draft in its current form could create an impression with creditors that they have access to assets which they otherwise did not and, as a result, risk the possibility that such assets would ultimately be subjected to "substantive consolidation" in

² See, for example, Nos. 25, 42, 90 & 127, as well as the attachment to Letter of Comment No. 46 which is also attached to several other Letters of Comment.

³ See, for example, Nos. 88 and 134. In passing, it seems curious that an entity constructed so rigorously as to possess that characteristic could ever be characterized as a "strawman" although that does seem to occur.

⁴ See, Fish v. East, 114 F.2d 177 (10th Cir. 1940). The fundamentals articulated in that case continue to be cited as authoritative in this area, although it is important to note that refinements continue to be made. One very visible instance of that occurred in the Drexel Burnham situation. See, In re Drexel Burnham Lambert Group, Inc., 138 B.R. 723 (Bankr. S.D.N.Y. 1992).

insolvency proceedings to the detriment of investors otherwise reasonably relying on the "bankruptcy remote" status of the SPE?

5. **Sarbanes-Oxley**

The Sarbanes-Oxley Act of 2002 was adopted in direct response to various highly visible instances of apparent wrong-doing in the corporate and accounting world. At least one very visible instance of that highlighted the use of SPEs. Under the Sarbanes-Oxley Act, the SEC is obligated to issue final rules by not later than January 26, 2003, regarding disclosure of off-balance sheet financing transactions, arrangements and obligations, as well as other relationships with unconsolidated entities which have a material current or future impact on the financial status of reporting companies. In this context, it is clear that an approach by the FASB which highlighted disclosure would be in harmony with the law and with initiatives by the SEC. It is not at all clear that an approach based instead on consolidation would also be in harmony and there is more than a theoretical risk that it would not be.

In addition, the Sarbanes-Oxley Act requires the SEC to conduct a study of filings by reporting companies to examine certain aspects of SPEs, including whether the application of GAAP results in meaningful reflection of off-balance transactions in a manner which is readily transparent to investors. The provision specifically requires that the study examine whether GAAP requires consolidation of such SPEs in appropriate circumstances.

Has the FASB considered whether it should at this time move in a different direction from that of the SEC or instead simply provide at this time specific guidance as to disclosure and then coordinate with the SEC on the initiatives in this area mandated by Sarbanes-Oxley?

6. **Lender Liability**

The Exposure Draft might be read to require that an institution which makes a loan to an SPE could be obligated to consolidate the assets and liabilities of that SPE in its own financial statements. Has the FASB considered the impact that could have on further expanding legal principles of "lender liability" -- either as a refinement of existing principles or development of an entirely new category based solely on such consolidation?

7. **Breach of Contract / Covenant Defaults**

Changes to accounting principles do not occur in a vacuum. Lenders and borrowers (as well as parties to other analogous financing transactions) routinely reach finely negotiated positions of debt coverage ratios and the like which depend for their assessment on reference to GAAP financial statements. Without any act by either party, one of them could find itself in a legally definitive position of breach of contract by virtue of covenant defaults or (at the other end of the spectrum) could find itself substantially less protected in its position than had otherwise been the basis of concluding a transaction. When that shift occurs, so does the relative negotiating positions. Has the FASB considered whether that result was intended for the proposed Interpretation? Has the FASB considered the legal and economic implications of that result?

8. State Law Formation/Organization Laws

State law can permit a business entity to have invested capital interests (which concept presumably covers that accounting concept of "equity") which have "... repayment provisions that are similar to the provisions of debt obligations or otherwise limit the holder to a rate of return commensurate with the risk in debt instruments."⁵ That could readily occur with respect to preferred stock, LLC membership interests, limited partnership rights, and even shareholder rights in close corporations. The FASB's determination that such characteristics would cause an SPE not to meet the exception conditions of Paragraph 9 should be examined as to whether the FASB intends to supplant functions regarding formation and organization of legal entities or if the stated position of the FASB could force a legal entity to forfeit protections otherwise assured to it (and to its investors and creditors) under state law.

9. State Law Dividend Restrictions

In many states, debt-coverage ratios and similar financial standards of capital adequacy which govern the ability of corporations or other legal entities to declare dividends or otherwise make distributions to its capital investors are based on financial statements prepared in accordance with GAAP. If the proposed Interpretation is adopted, legal entities into which investors put their money in reliance on continued dividend/distribution policies could suddenly be prevented from doing so. Has the impact of that on investor confidence in the accounting system been considered in the proposed Interpretation? Has the FASB taken into consideration state law implications on the personal liability of directors who authorize dividends based on currently existing standards when those cease to be applicable? This issue raises the specter that decisions made by Directors would subsequently be subject to a different standard of review if an SPE with which the enterprise had completed financing transactions were to go through seriatim iterations of consolidation and deconsolidation.

I hope that the foregoing is of some interest. Given the time it has taken to work my way through the Letters of Comment and then prepare this letter, it is reasonable to assume that the problems of accounting/legal interstices generally are not likely to be included in the discussions at the Roundtable, much less the specific issues referenced in this letter. The list of issues circulated Wednesday morning by Mr. Tatore do not readily lend themselves to that discussion and, although his cover message indicates that other issues may be raised if time permits, it seems relatively likely that ones of a more technical nature (and thus narrowly focused on accounting principles, irrespective of implications beyond that discipline) are more likely to receive attention of the participants. As and to the extent I can inject those briefly into the dialogue, I will hope to have the opportunity to do so.

Ms. Suzanne Bielstein
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September 26, 2002
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In any event, I would hope that member of the Board can be made aware in one manner or another that deliberations and then interpretations in this area do have an impact on the overlap of issues as between the legal and accounting disciplines. In its current form, the Exposure Draft does not appear to reflect that.

Very truly yours,

/s/

Steven K. Hazen

cc: Mr. Len Tatore via E-Mail: lrtatore@fasb.org