May 10, 2004

TA&I Director—Setoff and Isolation
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: FASB Staff Request for Information, April 9, 2004/
Setoff and Isolation (the “Request”)

Ladies and Gentlemen:

Attached is a statement of the author’s experience and expertise on subjects discussed in this letter.

This letter addresses the rights of parties to participation agreements of various types in specific circumstances addressed in the Request, based on court decisions. Its focus is primarily legal. Incentives of parties to enforce or waive rights will vary with circumstances, so they do not provide a sound basis for reliable presentation of financial condition.

A brief synopsis of participation law is also attached.

BACKGROUND

Fair and accurate reporting of the “ownership” of financial assets is essential for stability of financial markets and accuracy of accounting.

Depending on which side is viewed, “financial assets” are both the assets and the liabilities by which our nation’s financial system functions. They are the means for operating the “great wheel of circulation” (A. Smith) which supports the production of all goods and services. Fair and open trading of financial assets helps the real economy to operate efficiently and produce wealth.

Accurate accounting allocation and measurement of financial assets is not merely a matter which affects financial institutions. It is vital to all aspects of our economy. All who invest in, use and monitor the operation of financial markets (that is to say, everyone) must rely on the accuracy of books and records of financial institutions to assess the choices that they must make in business and investment on a day-by-day basis. There can be no transparency or fair competition in financial markets without accounting that accurately reflects transfers and leverage of the system’s financial assets.
Without accurate financial asset accounting, participants in our economy are left to “guess.” Precluding true transfers wrongly “creates” leverage that does not exist. Calling “debt” a “sale” wrongly “hides” leverage. In either case, financial markets become unstable, investors demand excess risk premiums and potential economic advancement is needlessly restrained.

Since the U.S. began to unwind financial market controls imposed during the Great Depression, many of the accounting profession’s most heated (and important) debates have focused, ultimately, on the fundamental question of who “owns” financial assets and who “owes” the liabilities they support. After decades of debate, legal ownership has emerged as the only reliable standard upon which to base accountancy in this vital area. This debate over participations is easily resolved by reliance on established case law and reinforces the wisdom of accounting reliance on a legal isolation standard.

Reliance on law is proper for two reasons. First, when law and accountancy reach compatible solutions, certainty and stability are encouraged; risk premiums fall and everyone benefits. Second, while law is sometimes difficult to ascertain, it is decided by a notably independent judiciary. When a major legal issue arises before a respected court in a dispute between well-represented sophisticated parties with significant monetary differences at stake, independent judges generally reach reliable conclusions.

Such is the case with legal standards applied to transfers of financial assets and participations. Courts have been well-briefed in many significant cases where decisions must be reached on who “owns” and “owes” financial assets and obligations. Many, many cases can be cited on these issues. Moreover, there are a few truly outstanding opinions of courts which have decided issues of asset ownership and setoff in situations where the wisdom of our judiciary shines forth clearly, creating a reliable base for the FASB’s decisions. All such opinions reach the same conclusions, making the law in this area very clear.

**SUMMARY OF LAW**

There are two basic forms of “participations” which are important to the Board’s analysis:

1. **In the commercial banking business**, loan participations (LPs) are used to spread risk using unsecured interbank loans that transfer liquidity among banks and lower an originating bank’s exposure to statutory lending limit violations. These participations are of particular concern among small banks with fairly low legal lending limits, because bank directors have personal liability for loss on a loan which exceeds lending limits. GAAP reporting of participations makes no difference, however, on the lending limit relief that a participation provides.

2. **In the residential mortgage business**, participations involving transfers of loans are used to facilitate trading of pro-rata shared interests in diversified pools of consumer mortgages. Mortgage participations (MPs) actually have a history dating to the 19th Century. They have become popular in the U.S. since bank deregulation began in the early 1970s, and can easily be adapted to any financial asset.
An LP is a loan by the participant to the lead lender because it does not involve an assignment or transfer of the underlying asset. An MP is a sale because the underlying asset is transferred for the benefit of participants.

Assuming the same liquidity/intermediation cost, the FDIC would likely prefer that banks use LPs over MPs because an LP creates a general obligation of the lead bank which, in receivership, is often subordinate to claims of the FDIC as the insurer of deposits. An MP, because it involves an asset transfer, commonly gives the participant priority over the FDIC with respect to the participated asset.

When an LP agreement provides no security interest in the underlying loan, the participant’s loan to the lead bank is subordinate to all depositors of the bank, generally making it worthless in receivership of the lead bank (regardless of setoff issues). If the LP agreement is a loan which creates a security interest in the underlying loan, to the extent of any setoff, the participant’s claim for a share of the setoff will be subordinate to depositors.

From the FDIC’s perspective, participants are general creditors and under the 1989 FIRREA legislation, in receivership creditors lose.

MPs are commonly issued by stand-alone structures rated separately from the loan originator/servicer, in order to reduce intermediation costs. To be rated at a level sufficient to be marketed advantageously, most lenders that create private MPs must isolate the mortgage loans, by an assignment or transfer, and have the isolated entity create and/or issue the MPs.

Case law, dating back decades, supports effectiveness of the MP isolation process and its ability to sever setoff rights. Since the mortgage loans have been transferred (and are, therefore, isolated), the mortgages are not included in receivership assets of a bank that structures the MP or in the bankruptcy estate of a non-bank mortgage seller. Therefore, mortgage borrowers are not entitled to offset deposits of the seller against the mortgages in the case of MPs. It does not appear that the FDIC has ever contested the validity of the normal MP isolation process.

Differences between transactions which “transfer” financial assets (MPs) and those which only create interbank obligations (LPs) are, perhaps, best illustrated by a case cited in response to questions below. Bank B transferred a loan to its affiliate (bank A) prior to default by the borrower. Bank A held a deposit account with the borrower. Because there was a transfer of the loan, A was entitled to offset the loan and the deposit.

To fund B’s transfer of the loan to A, concurrent with the transfer, B loaned A the amount of (and purchase price of) the borrower’s loan and received a 100% LP from A. A did not go into receivership and honored its LP agreement to pay B 100% of the deposit setoff.

If the LP transferred the loan back to B, setoff would not have been allowed (due to lack of mutuality), and B would have suffered a loss. The Court upheld the setoff, however, because the LP was an interbank loan that did not transfer the loan back to B.
This distinction, transfer versus loan, is the fundamental legal basis for the conclusions reached in all of the cases which the FDIC has provided to the FASB that permit FDIC, as receiver for a lead bank in receivership, to set off deposits of borrowers under loans that have been participated by lead banks using LPs.

**RESPONSES TO QUESTIONS IN THE REQUEST**

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?"

**Response:**

Not completely.

The Request says:

"If one of the parties in a mutual debtor-creditor relationship transfers all or a portion of its financial asset (the amount receivable from the other party) to a third party, the right of setoff between the first two parties may not be eliminated." (emphasis added)

The underlined words, read as a sentence, do not accurately reflect the law of participation and setoffs. Upon a "transfer," the common law right of a debtor and creditor to offset mutual matured claims is always severed. Setoff is not eliminated in the case of an LP because an LP involves no "transfer," it is merely a loan by the participant to the lead lender.

The concluding sentences of the paragraph in the Request that is partially quoted above would permit accountancy to reflect the UCC, case law on participations and transfers, setoff law, bank receivership law and bankruptcy law, if it 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. The following discussion of loan participations illustrates the point."

This accommodates LPs and MPs. Where a transfer does, in fact, occur (an MP), there is no common law setoff with the transferor. This distinguishes MPs from LPs.

**ADVANTAGES OF LPs AS "LOANS."**

The issue in common law setoff cases is whether a "transfer" exists by virtue of a particular agreement. As detailed below, common law setoff rights always "follow" the transfer. (so setoff cannot exist between a transferor and the borrower on a transferred loan). Participations (for example, LPs) do not sever common law setoff rights and, therefore, are not "transfers."
The two-bank case showing the difference between rights obtained by an "assignment" (transfer) of all or a portion of a financial asset and a typical bank LP is *Depositors Trust Co. of Augusta v. Frati Enterprises, Inc.*, 590 F.2d 377, 379 (1st Cir. 1979). The two affiliated banks used the law on transfers and participations to maximize recovery from a debtor on the verge of bankruptcy by an assignment from an affiliate with no deposits to one with substantial deposits. That created a debtor-creditor relationship between the transferee and the debtor, maximizing the two banks' collection rights.

B funded A's purchase of the note by buying a 100% LP in the note back from A. The Court held the assignment allowed A to offset the reserved deposit (mutuality passed to A by the assignment, but mutuality did not pass back to B by the LP). The LP then permitted A to pass the funds to B under the LP (there was no intervention of a receivership to prevent A's payment of its obligation to B under the LP). B was a general creditor of A which A was free to pay B, because A was not in receivership.

**Statutory Provisions on MPs and LPs.**

The *Frati Enterprises* result is incorporated into the new UCC because the UCC adopts case law on the issue of whether a particular agreement creates a "sale" and says that where a sale exists, there is no need for filings to create rights to assets. The assignment from B to A would be recognized as a sale. Where the agreement does not "sell" an asset under case law (e.g., an LP), other steps are required to create protection for the participant under the UCC.

All cases cited to the FASB by the FDIC reach this same result. Absent an assignment of the underlying financial asset, a participant has only a claim against the lead bank, and no claim against the underlying obligor. The LP form of participation does not transfer or assign the underlying asset, so it does not constitute a sale under case law or the UCC.

The rights of a participating bank in the lead bank's receivership when it acquires a participation without an effective assignment or transfer of the underlying obligation are defined by the Federal Deposit Insurance Act and cases the FDIC has provided the FASB. They may be summed up as follows:

The participant is simply a general creditor. Any set-off of a deposit allows the elimination of an asset and liability of the receiver - and the participant gets whatever share of the set-off to which it may be entitled under depositor preference rules, as a general creditor of the institution in receivership.

The "share" to which the participant is entitled under deposit preference rules will often be $0. As a "general creditor" of a bank in receivership, the "participant" owns no rights to the underlying asset. Since 1989, § 11(d)(11)(A) of the Federal Deposit Insurance Act has held that a general creditor is subordinate to all claims of depositors (depositors' claims commonly exceed the value of the bank's assets in receivership).

If FDIC effectively waives its right to subordinate a participant to FDIC's claim on behalf of insured depositors (and there is no indication that it has done so to date), uninsured depositors...
of the bank could, it appears, still preclude payment to the participant until uninsured depositors are paid in full.

From FDIC’s view: “If the bank fails, creditors lose.”

Treatment of participants in the event a non-bank lead lender becomes a debtor under the Bankruptcy Code is complicated by the “mortgage servicer” exception in § 541(d) of the U.S. Bankruptcy Code. The exception clearly excludes property supporting MPs (where assets are, in fact, assigned) from being property of a servicer in bankruptcy. It also allows LP holders that would otherwise lose money as general creditors of an insolvent non-bank lender to argue that a preferential right to specified assets is created, though decisions are split as to whether a participant has any priority over general creditors.

Unlike setoff issues where “transfer or assignment” creates a clear point of separation, there are issues of equity on both sides of a § 541(d) debate between general creditors and holders of LPs. This is most prevalent in cases where LPs are sold to small individual investors and general creditors are large institutions that can spread risk of loss more efficiently. Some cases have allowed LP holders priority under § 541(d) that they do not enjoy in setoff cases. Since there is still no “transfer,” however, prior to bankruptcy, the original owner still controls the asset, so accounting should not be affected by those cases.

The “mortgage servicer” provision of the Bankruptcy Code excludes from “property of the estate”:

Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest, such as a mortgage secured by real property, or an interest in such a mortgage, sold by the debtor but as to which the debtor retains legal title to service or supervise the servicing of such mortgage or interest, becomes property of the estate under subsection (a)(1) or (2) of this section only to the extent of the debtor’s legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold. (11 U.S.C. § 541(d))

The split of authorities under § 541(d) is one factor which makes legal “true sale” opinions laboriously long. By its terms, § 541(d) only applies when the servicer has no beneficial interest in the assets and has conveyed “equitable interests” to others. The creation of an “equitable interest” generally requires the creation of a “trust,” as occurs in the case of MPs. It has clear application, therefore, in cases of MPs where the originator/servicer transfers the debt to a custodian but remains record titleholder of the mortgage only to service the assets. In the case of an LP, the better reasoned cases hold that no “interest” is conveyed at all.

As a result of disparities among creditors, § 541(d) decisions are not particularly reliable as indicators of whether legal isolation exists.
GENERAL LAW, ADVOCACY AND SECONDARY SOURCES.

When the issue is whether a participant and an underlying debtor can set off claims when the lead is in bankruptcy, bankruptcy cases accord with banking law and find that only the lead bank and debtor can set off, unless the underlying asset is transferred. In re Yale Express Systems, Inc., 245 F.Supp. 790 (S.D.N.Y. 1965); Mason & Dixon Lines, Inc. v. First Nat'l Bank of Boston, 86 B.R. 476 (M.D.N.C. 1988), aff'd, 883 F.2d 2 (4th Cir. 1989); In re Felicity Assoc., 197 B.R. 12 (Bankr. D.R.I. 1996); Depositors Trust Co. of Augusta v. Frati Enterprises, Inc., 590 F.2d 377 (1st Cir. 1979).

While decisions on common law setoffs and participations appear very clear, many articles have been written where particular advocates suggest what the law of participations “should be.” These articles provide arguments for changing the law of participations to grant direct rights to participants. To change the law, however, would cut against the interests of lenders, e.g., Frati Enterprises, Inc. No matter how persuasive arguments for change may seem, therefore, they are not likely to be adopted by independent courts in cases involving sophisticated parties.

The new Article 9 of the Uniform Commercial Code is a good example of where advocacy and reality clashed, and reality prevailed. The new UCC says that where a participation is a “sale” (e.g., an MP), there is no need for further action by a participant to perfect its interest in the asset. With regard to LPs, some advocates hoped that the new UCC would somehow “confer” sale treatment (and some assert that occurred). The drafters, however, avoided doing so.

After reciting that a “sale” of a loan “includes a sale of a right in the receivable, such as a participation interest,” the official comment to the new UCC reiterates that whether a particular transaction is, in fact, a sale, remains a matter of case law:

[N]either this Article nor the definition of “security interest” . . . delineates how a particular transaction is to be classified. That issue is left to the courts. UCC 9-109 Official Comment 4 (emphasis added).

Thus, it is only by the examination of case law applied to specific transactions that one can determine whether a participation constitutes a “sale,” the grant of a security interest or a mere obligation of the lead bank to the participant. Many lenders, of course, want the law of participations to remain unchanged to preserve rights illustrated by Depositors Trust Company of Augusta vs. Frati Enterprises, Inc. (supra). In that case, the difference between a participation and a transfer increased collection of debts by transferring the loan to an affiliate and leaving it there by a participation. Since lending limit relief of participations is unaffected by holding that LPs are loans, many support the case law result that LPs are loans.

PRIMARY AUTHORITIES.

In 2000, an opinion on claims under participations (LPs) was written in a well-briefed, strongly contested case between sophisticated parties, before a respected Bankruptcy Court. In
re Okura & Co. (America), Inc., 249 B.R. 596 (Bankr. S.D.N.Y. 2000). The opinion thoroughly analyzed all precedents on participations and ruled against a major bank, The Bank of Tokyo-Mitsubishi ("BTM"), where BTM sought a ruling that an LP was a sale of the underlying loan.

The Court ruled that BTM obtained no right whatsoever as a creditor of the debtor by holding a participation (LP) in the debtor’s loan acquired from another large bank. The opinion provides a thorough and systematic analysis which covers all aspects of the questions before the FASB.

Judge Gallet decided the case. He analyzed all the arguments, pro and con, relating to a participant’s rights to assert claims on the underlying loan in a borrower’s bankruptcy. He found the loan participation did not result in a partial assignment, create a tenancy-in-common or transfer any interest in the loan to BTM. Thus, the participant (BTM) had no “claim” of any kind against the underlying debtor which gave it “creditor” status.

He found case law to be unambiguous—a participation that does not include a transfer or assignment of an underlying asset only creates a claim against the lead bank. The lead bank alone, therefore, has common law setoff rights with the debtor (and the participant cannot assert a “claim” against the debtor). Where a participation is supported by a transfer or assignment of the asset, however, the exact opposite result occurs. Where a transfer occurs, the transferee alone can assert setoff.

In Okura, BTM sought to file a claim against the debtor arising under a participation it acquired from Fuji Bank, Limited (Fuji). The Court analyzed the terms of the specific participation. It was a typical LP where Fuji retained the relationship with the debtor.

The trustee for the debtor in that case sought to preclude BTM from asserting a “claim” against Okura based on the LP because the debtor would have had to pay BTM considerably more as a creditor than as a mere participant. The judge found the agreements “and the case law regarding participation agreements do not support BTM’s assertion that it may assert a claim against the Debtor because BTM is not a creditor of the Debtor.” (Id. at 601).

The Court decided to write a detailed analysis because “the treatment of loan participation agreements by Bankruptcy Courts is of general importance in the commercial world.” (Id.)

In support of its ability to claim as a creditor of Okura, BTM made five arguments:

“First, BTM argues that it is entitled to file a claim because of the broad definition given to the words ‘creditor’ and ‘claim’ under the Bankruptcy Code. See 11 U.S.C. §§ 101(5) and 101(10) (2000). Next, it contends that there is binding Supreme Court and Court of Appeals of the Second Circuit precedent on point which I am constrained to follow. See Small Business Admin. v. McClellan, 364 U.S. 446, 81 S.Ct. 191, 5 L.Ed.2d 200 (1960); In re The Westover, Inc., 82 F.2d 177 (2d Cir. 1936). Third, BTM claims that it is a tenant-in-common in the LCA with Fuji, and, therefore, has a right to assert a claim directly against the Debtor.
Fourth, BTM maintains that the way it and Fuji were required to treat the LCA and the Participation Agreement in their books, pursuant to prevailing federal banking laws, supports the conclusion that the Participation Agreement affected a partial assignment and complete divestiture of the participated portion of the LCA to BTM from Fuji. Finally, BTM asserts that I should consider the Extrinsic Materials which, it contends, demonstrates the parties' relationship during the time that BTM and Fuji executed the Participation Agreement and also the intent of the parties at that time. It should be noted at the outset, however, that BTM does not contend that the Participation Agreement is ambiguous.” *Id.* at 601-602.

These are, in fact, the basic arguments made by advocates that support a proposition that LPs, without assignments of the underlying financial assets, should be deemed “sales” for various purposes, including GAAP. To prevail on any one of the five arguments would contradict case law which supports banks’ affirmative use of the distinctions between assignments and LPs to create the collection benefits exemplified by the *Frati Enterprises* case discussed above. It is only by the Court’s rejection of all five arguments made by BTM that a consistent legal framework to distinguish LPs and MPs can exist.

Fortunately, the Court penetrated each of BTM’s arguments and established the framework FASB needs to resolve these issues:

**BTM ARGUMENT (1) Did BTM obtain a “claim” by its purchase of the LP which would make it a “creditor” of Okura? Answer: NO.**

“The word ‘claim’ is interpreted broadly under the Bankruptcy Code. (‘Courts have characterized the term “claim” as, *inter alia*, “broad,” “very broad,” “extremely broad,” the “broadest possible,” “all-encompassing,” and “sufficiently broad to cover any possible obligation” to make payment.’ (citations omitted)). It was Congress’ intent, in defining ‘claim’ so broadly, that ‘all legal obligations of the debtor, no matter how remote or contingent, [would] be able to be dealt with in the bankruptcy case....’ (‘[b]y this broadest possible definition, and by the use of the terms throughout Title 11, [Section 101(5)(A)] contemplates that all legal obligations of the debtor, no matter how remote or contingent, will be able to be dealt with in the bankruptcy case.’).” 249 B.R. 596 at 602 (citations omitted).

While extremely broad, the Court noted that “claim” is not “unlimited”:

“In order for a claim to arise there must be a ‘right to payment.’ .... And, a ‘right to payment’ is nothing more than an enforceable obligation.” *Id.*
Therefore, the Court needed to decide whether the LP gave BTM "an enforceable obligation against the Debtor under non-bankruptcy law." That is, whether the LP "sold" any interest in Fuji's loan to BTM.

The LP agreement contained standard language purporting to transfer a share of the loan to BTM, called an "Undivided Interest and Participation Clause."

"We hereby confirm that we are to sell and transfer to you, and that you are to buy and receive, an undivided interest and participation to the extent of 22.5% (your 'Percentage Share') in and to the Letters of Credit and the obligations of [the Debtor] in respect of the Letters of Credit under the Letter of Credit Agreement, on the following terms and conditions." Id. at 604.

As is customary in LP cases:

"BTM argues that the Undivided Interest and Participation Clause can only be read to mean that Fuji affected a partial assignment of the LCA creating a joint loan or a tenancy-in-common with Fuji. In addition, BTM argues that after the assignment, Fuji's role, with respect to the portion of the LCA which BTM participated in, is that of a mere collection agent." Id.

The Court analyzed the whole relationship (among the Debtor, Fuji and BTM) to determine whether there was intent to "bestow . . . on BTM" a right to enforce or collect the loan. The Court found against BTM:

"BTM is insulated from any obligation to the Debtor . . . . It is not logical, therefore, to read an obligation of the Debtor to BTM . . . . The Undivided Interest and Participation Clause was unambiguously intended by the parties to convey to BTM less than a partial assignment." Id.

This conclusion of the Court was footnoted as follows:

"In coming to this conclusion, I note that under New York law the Participation Agreement does not create a tenancy-in-common and that other courts have treated participants vis-à-vis borrowers in analogous situations similarly." Id. at 605.

Thus, in holding that BTM was not a creditor of Okura, the Court found no support for an assertion that the LP assigned, transferred or sold to BTM any interest in the Fuji loan to Okura. The LP, moreover, did not create an interest equivalent to a tenancy-in-common, an argument for GAAP "sale" treatment that has also been asserted to the FASB.
BTM ARGUMENT (2) Is there binding precedent that requires the Court to rule BTM was a creditor of Okura? Answer: NO.

The Court considered all of the supposed contrary precedents that BTM asserted to the Court:

"In the face of paragraph 10, and the rest of the Participation Agreement, which clearly demonstrates the parties' understanding that only Fuji would have the right to assert a claim directly against the Debtor for breach of the terms of the LCA, BTM argues that binding, if aged, Supreme Court and Second Circuit authority supports its position that the Undivided Interest and Participation Clause granted BTM an ownership interest in the underlying LCA and the right to assert a claim directly against the Debtor." *Id.*

(A) SBA Loans

BTM suggested that a U.S. Supreme Court decision on Small Business Administration (SBA) loans bound the Court to finding in BTM's favor.

"The first case that BTM argues is controlling is *Small Business Admin. v. McClellan*, 364 U.S. 446, 81 S.Ct. 191, 5 L.Ed.2d 200 (1960). BTM contends that '[t]he Supreme Court stated that the SBA, because it was a participant in the loan, owned a distinct claim as a creditor of the bankrupt....' *BTM's Response to Debtor's Motion to Reduce BTM's Claim No. 150* at 5-6. Based upon this 'statement,' BTM concludes that I must find in its favor." *Id.* (footnotes omitted).

Since issues relating to SBA loans are of concern to the FASB, the Court's discussion of those transactions may be helpful to the Board:

"Contrary to BTM's assertion about the holding in *McClellan*, however, it is apparent that the Supreme Court was concerned about something very different from the rights of participants to assert claims in bankruptcy. In fact, the *McClellan* decision does not even mention the words 'participant' or 'lead bank.' Nor does the Court discuss whether participants have a right to assert a claim against a debtor-borrower. Even the word 'participation' is used only once in the decision in a policy discussion toward the end of the opinion regarding the policy implications of allowing the SBA to effectively share the government priority it enjoys in bankruptcy proceedings with a private bank that joined the SBA in making a loan to the debtor. *See McClellan*, 364 U.S. at 451-52, 81 S.Ct. 191."
"The facts in McClellan, as articulated by the Supreme Court, are simple and quite distinct from the facts here. The SBA jointly lent $20,000 to the debtor, $5,000 of the loan having come from the funds of a private bank and $15,000 from the Government Treasury. *Id* at 447, 81 S.Ct. 191. The issue before the Court was 'whether, when the Administration has joined a private bank in a loan and the borrower becomes bankrupt, the Administration's interest in the unpaid balance of the loan is entitled to the priority provided for “debts due to the United States” in R.S. § 3466 and § 64 of the Bankruptcy Act, even though the Administration has agreed to share any money collected on the loan with the private bank.' *Id*.

"Why then does BTM rely on a case so dissimilar from the facts presented here? In order to answer this question it is necessary to examine the Court of Appeals and District Court opinions which preceded the Supreme Court decision relied upon by BTM. In each of those decisions, the deciding court focused on a different aspect of the facts before it. The District Court believed that the relationship between the debtor, the private bank and the SBA was that of borrower, lead bank and participant respectively. See *In re Byquist*, 168 F.Supp. 483, 484-85 (D.Kan.1958). In particular, the District Court focused on the facts that the debtor applied to the private bank for the loan, that the SBA paid more than $15,000 to the private bank, and that the private bank, in turn, lent the money to the debtor. *Id*. In addition, the District Court noted that the note executed by the debtor obligated him to pay the private bank only, albeit in accordance with conditions which referenced the SBA. *Id*. Finally, the District Court noted that following the debtor’s filing for bankruptcy, the bank assigned the note to the SBA. *Id*. The issue before the court was whether the SBA is entitled to an administrative priority for its claim. *Id* at 483-84. Interestingly, the District Court held, in part, that based upon the facts before it, which are similar to the facts before me, the SBA, as a participant, could not seek payment directly from the debtor based upon the note between the debtor and the private bank. *Id* at 486. ‘Until the assignment of the note by the bank to the Small Business Administration there was no means by which Small Business Administration could force the bankrupt to make any payments to it even in the event that the bank refused to carry through the agreement between the bank and Small business Administration.’" *Id*.

"The Court of Appeals affirmed the District Court on different grounds. The court pointed out that the debtor applied for the loan
in question ‘on a Small Business Administration form, entitled “Limited Loan Participation Application for Loan” ....’ Small Business Administration v. McClellan, 272 F.2d 143, 144 (10th Cir. 1959). The note also provided that the debtor agreed to reimburse the holder and the SBA for any expenses incurred by them in connection with the loan. See id. Furthermore, the private bank only agreed to lend the money to the debtor if the SBA provided 75 percent of the cash. Id. Finally, the private bank agreed that on five days written demand, it would transfer the note to the SBA and that the holder of the note would service it and remit to the other party its pro rata share. Id.

“Since the Court of Appeals identified several unique facts that set the case before it apart from a typical loan participation situation, it is not surprising that the court did not focus or even discuss SBA’s rights as a participant. Instead, the court focused on whether the SBA was standing in the shoes of the United States or a private party by virtue of its agreement to share the proceeds and any distribution ratably with the private bank. Id. at 145-46.

“Based upon the facts identified by the Court of Appeals, it is clear why the Supreme Court treated the loan at issue as a joint loan instead of a participation. McClellan, 364 U.S. at 447, 81 S.Ct. 191. It is for these same reasons that this case is not binding here: the debtor used an SBA form to originate the loan; the SBA had the unilateral right to take possession of the note and the debtor agreed to reimburse the SBA for its expenses incurred in connection with the loan. McClellan, 272 F.2d at 144. Here, in contrast, the LCA was exclusively between Fuji and the Debtor. BTM was not mentioned in the LCA. In addition, BTM has no right under either the LCA or the Participation Agreement to unilaterally take possession of the note. Since both the facts and the questions of law before the Court in McClellan were different from this case, I find that it is not binding here.” Id. at 605-607 (footnotes omitted).

Thus, the treatment of SBA loans is as a joint loan, clearly distinguished from normal LPs. The SBA is specifically mentioned throughout the lending process and, at the time it asserts rights, it has been assigned the financial asset which it proceeds to enforce. Those factors do not exist in a standard LP. In an MP, where the loan is actually assigned to an entity separate from the original lender, the factors which allow the SBA to proceed as an owner of the loan are present.
(B) **Participations in Transferred Loans (MPs)**

Next, BTM presented the Court a 1936 decision of the U.S. Court of Appeals for the Second Circuit. The decision did not support BTM’s claim, but it well-distinguishes MPs from LPs. *In re The Westover*, 82 F.2d 77 (2nd Cir. 1936).

“In *The Westover*, the court was faced with a situation where the Prudence Company issued certificates to individual investors for assignments of undivided shares in a mortgage. The Prudence Company did not hold title to the underlying mortgage in which the certificate holders had been sold an interest. Rather, nominal title was vested in a bank which held title in trust for the benefit of the certificate holders. The Second Circuit affirmed the District Court’s confirmation of a plan of reorganization supported by the individual certificate holders, but opposed by the Prudence Company. The court concluded that the Prudence Company could collect payments made on the underlying mortgage only as agent for the certificate holders, because the Prudence Company, except to the limited extent that it was also a certificate holder, had no direct claim against the underlying mortgagor. Significantly, the court came to its conclusion, in part, because the underwriter of the participation certificates had represented that the certificates were outright assignments of the mortgage loan itself. Finally, the Second Circuit also noted that the Prudence Company had assigned all of its interest in the mortgages to a wholly owned subsidiary and, therefore, relinquished any interest it had in the mortgages.” *Id.* at 607 (citations omitted).

There are striking similarities between the facts in *The Westover* and those in “two-step” (MP) structures which are the focus of paragraph 83 of SFAS 140. The mortgages were sold to a wholly owned subsidiary (the “BRSPE” of modern securitization transactions) and then assigned to a trustee for the benefit of participants, including the transferor (the forerunner of today’s “QSPE”).

The Court contrasts the MPs of *The Westover* with the LP owned by BTM as follows:

“Here, in contrast, Fuji holds title, not as a mere agent, but as a direct lender, with a direct claim. Furthermore, the Participation Agreement, when read in its entirety, does not provide that an outright assignment to BTM was affected, since, for example, BTM did not retain the right to freely alienate its share. Therefore, the facts of *The Westover* and the agreement at issue in that case...
are factually distinguishable from the Fuji-BTM agreement and the facts of the matter before me.” *Id.*

(C) Other Participation Precedents

The Court summarizes the development of law on participations since *The Westover*:

“Since it was decided in 1936, the use of and the law relating to participation agreements has evolved significantly. During this period, many courts have grappled with questions similar to the one facing me, whether a participant may assert a claim directly against a debtor-borrower. Every one of the cases holds that participants may not.” *Id.*

The distinction between different types of participations, ultimately, rests on the issue of whether the underlying loan is “transferred” or otherwise owned by or for the benefit of participants, creating direct or indirect “privity” between a debtor and the participant. In the case of an LP it is not, but in the other cases a transfer has occurred to a separate entity which isolates the participants’ right to the underlying loan. In the case of LPs:

“As a general rule, the participants do not have privity of contract with the underlying borrower. See *id.* In an interbank loan, one bank lends the funds of another bank which, in turn, lends to the borrower. In a syndication agreement, the banks jointly lend money.” *Id.* at 608.

The Court in *Okura* cites the following cases as authority which persuasively supports its conclusion:

“*First Nat’l Bank of Louisville v. Continental Ill. Nat’l Bank and Trust Co. of Chicago*, 933 F.2d 466, 467 (7th Cir.1991) (noting that in a typical participation arrangement, ‘only the lead bank has a direct contractual relationship with the borrower.’); *Hibernia Nat’l Bank v. F.D.I.C.*, 733 F.2d 1403, 1407 (10th Cir.1984) (holding that participants may ‘look solely, to the lead for satisfaction of their claims because they are not themselves creditors of the borrowers and cannot assert creditor claims against the borrowers.’); *Depositors Trust Co. of Augusta v. Frati Enters., Inc.*, 590 F.2d 377, 379 (1st Cir.1979) (finding that the lead bank, rather than 100% participant, is a creditor of the borrower); *Natwest USA Credit Corp. v. Alco Standard Corp.*, 858 F.Supp. 401, 408 (S.D.N.Y.1994) (stating that a ‘participant is not a lender to the borrower and has no contractual relationship with the borrower.’); *Mason & Dixon Lines, Inc v First Nat’l Bank of
Boston, 86 B.R. 476, 480 (M.D.N.C.1988), aff'd, 883 F.2d 2 (4th Cir.1989) (concluding that 'participants are not generally creditors of the borrower. Accordingly, any collections and filing of proofs of claim in bankruptcy should be made by the party to whom the underlying obligation is owed, namely the lead lender.'); In re Yale Express Sys., Inc., 245 F.Supp. 790, 792-93 (S.D.N.Y.1965) (holding that a loan participant is not a creditor of the debtor-borrower); In re Felicity Assocs., 197 B.R. 12, 14-15 (Bankr.D.R.I.1996) (holding that only the lead bank is a creditor of the debtor); In re Consolidated Properties Ltd. Partnership, 170 B.R. 93, 96 (Bankr.D.Md.1994) (holding that only the lead lender, and not the participants, may vote to accept or reject a plan of reorganization as the creditor who holds the claims underlying the loans); In re Coronet Capital Co., 142 B.R. 78, 81 (Bankr.S.D.N.Y.1992) (stating that it 'adopt[s] Yale's holding. A true participation agreement is one that ... only the lead can seek legal recourse against the borrower ...'); F.D.I.C. v. Adams, 187 Ariz. 585, 931 P.2d 1095, 1104-05 (App.1996) (holding that the participant cannot sue the borrower to enforce the loan agreement because it has no legal relationship to the borrower); Bank of Chicago v. Park Nat'l Bank, 266 Ill.App.3d 890, 203 Ill.Dec. 915, 640 N.E.2d 1288, 1296 (1994) (stating that '[p]articipants can look only to their lead bank for satisfaction of claims arising out of the transaction; they are not themselves creditors of the borrower and so cannot assert creditor claims against the borrower. '); First Bank of WaKeeney v. Peoples State Bank, 12 Kan.App.2d 788, 758 P.2d 236, 238 (1988) (noting that '[t]he participant bank has no legal relationship with the borrower. The borrower's and participant's relationships are solely with the lead bank.'); First Nat'l Bank of Belleville v. Clay-Hensley Comm'n Co., 170 Ill.App.3d 898, 121 Ill.Dec. 411, 525 N.E.2d 217, 221 (1988) (concluding that 'so far as the participation loan is concerned the lead is the only party empowered to collect it since the lead is the only party to whom it is owed.' (internal quotations omitted)); Corporate Financing, Inc. v. Fidelity Nat'l Title Ins. Co. of New York (In re Corporate Financing, Inc.), 221 B.R. 671, 678 (Bankr.E.D.N.Y.1998); In re Autostyle Plastics, Inc., 216 B.R. 784, 791 (Bankr.W.D.Mich.1997), aff'd sub nom. Bayer Corp. v. Mascotech, Inc. (In re Autostyle Plastics), 1999 WL 1005647 (W.D.Mich.1999); European Am. Bank v. Sackman Mortg. Corp. (In re Sackman Mortg Corp.), 158 B.R. 926, 933 (Bankr.S.D.N.Y.1993); Continental Fed. Sav. Bank v. Centennial Dev. Corp., 1991 WL 834856, *1, 23 Va.Cir. 275 (1991)." Id. at 608-609.
Many of these cases involve setoff rights. They are unanimous in concluding that the LP does not transfer any interest in the loan to the participant. In the absence of a transfer, setoff rights remain between the lead bank and the debtor. The participant has acquired only an obligation of the lead lender. As a result, the lead lender is entitled to (and subject to) setoff.

The participant (BTM in the Okura case) is not a creditor of the borrower (and is not entitled to setoff) because the LP transfers no interest in the loan to the participant.

BTM fought hard because it stood to gain over $900,000 if it prevailed. The Court was not impressed, however, and summarized its findings as to the quality of BTM’s legal analyses as follows:

“BTM attempts to muddy the otherwise clear picture that emerges from examining the authority in other jurisdictions by citing to a series of dissimilar cases which it contends stand for propositions in support of its case.” Id. at 610.

Case law on whether a loan participation “transfers” any interest in the loan is, therefore, very clear. It does not do so. BTM was not a “creditor” of Okura under even the very broad definition of “claim” set forth in the U.S. Bankruptcy Code. It could not, therefore, obtain a right to set off any deposit of Okura against its LP because the LP gave BTM no rights against Okura.

**BTM ARGUMENT (3) Did the participation make BTM a tenant-in-common with Fuji? Answer: NO.**

The Court presented this issue as follows:

“BTM next argues that, under New York law, the Undivided Interest and Participation Clause should be construed to grant BTM the rights of a tenant in common with Fuji in the LCA. In order for a tenancy in common to exist ‘two or more persons [must] each own and possess an undivided interest in property, real or personal.’ Chiang v. Chung, 137 A.D.2d 371, 529 N.Y.S.2d 294, 295 n. 1 (1st Dept. 1988). A tenancy in common, therefore, is created when a holder of an ownership interest in property assigns part of that interest to another party. Here, since only Fuji is a party to the LCA, the question is whether the Participation Agreement affected a partial assignment of Fuji’s interest to BTM. Under New York law that question must be answered in the negative.” Id. at 613 (footnote omitted).

Analyzing New York law, the Court distinguishes LPs from tenancies-in-common:
"The rights created by a tenancy in common are very different from those created by a participation agreement. 'Under New York law, an assignment occurs only where the assignor retains no control over the funds, no authority to collect and no power to revoke.' Here, none of these factors are present. Fuji, not BTM, retains almost complete control over the funds and the collateral. In addition, Fuji is given the sole right to collect monies under the LCA or to enforce rights in the event of a default. Furthermore, under the Participation Agreement, BTM does not have the right to assign its interest absent written consent from Fuji. See Miller v. Wells Fargo Bank Int'l Corp., 540 F.2d at 558 ('[a]n assignment at law contemplates "a completed transfer of the entire interest of the assignor in the particular subject of the assignment, whereby the assignor is divested of all control over the thing assigned."') Since BTM has none of the ownership rights typically associated with a tenant in common, I find this argument lacking in merit." Id. (citations omitted).

The factors which support a tenancy-in-common analysis exist in the typical two-step MP transaction (using a BRSPE and a QSPE) and where a bank transfers assets to a trust that issues securities (which is both a BRSPE and a QSPE, e.g., a "master trust"). In the case of MPs, absolute assignment of the loan to a BRSPE (or a combined BRSPE/QSPE) moves control of the asset to an entity which is so constrained as to pass legal "control" to investors in the MPs. The factors listed by the Court are made a part of Statement 140 for MPs by requiring that there be a determination that the financial asset in which MPs are created must be legally isolated. That never occurs for a typical LP.

**BTM ARGUMENT (4) Does treatment for federal banking law purposes change the treatment of BTM? Answer: NO.**

LPs provide the lead lender with relief from lending limit rules and capital requirements despite the fact that an LP transfers no interest in the asset. Indeed, as discussed herein, the fact that the asset is not transferred by an LP serves regulators' purposes by making participants mere general creditors of the lead bank. Since participants receive no rights to the lead bank’s asset but provide the lead bank with funds on a basis which may, in fact, be subordinate to depositors, the ability of the FDIC to defeat participants in receivership is greatly enhanced because the LP creates no transfer.

Thus, lending limit relief is supported if an LP is a mere loan. A similar analysis applies to regulatory capital rules. Where accuracy of disclosure is the issue (e.g., proper GAAP), the fact that LPs are loans and MPs are sales should be paramount.

**BTM sought to use the banking law characterization of LPs as a "sword" to gain greater rights against Okura. The Court did not accept that:**
"I disagree with BTM that this regulation has any relevance to the matter before me. In this case, the parties contractually agreed to limit BTM’s rights and obligations under the Participation Agreement. They could have entered into a different type of arrangement with different rights and responsibilities, but they chose this one. Thus, I reject this argument as irrelevant." *Id.* at 614.

The facts in *Okura* arose before the FDIC adopted 12 CFR § 360.6, “Treatment by the Federal Deposit Insurance Corporation as conservator or receiver of financial assets transferred in connection with a securitization or participation” (the “Regulation”). Does the Regulation affect case law on LPs and does it support the proposition that an LP, which neither assigns nor transfers any interest in a loan to a participant, constitutes a sale for legal or accounting purposes?

“Participation” is defined by the Regulation as:

“the transfer or assignment of an undivided interest in all or part of a loan or a lease from a seller, known as the ‘lead’, to a buyer, known as the ‘participant’, without recourse to the lead, pursuant to an agreement between the lead and the participant.” 12 CFR § 360.6(a)(3) (emphasis added).

Whether an agreement “transfers or assigns” any asset for FDIC purposes is a matter left to state law. That law (as discussed herein) unambiguously concludes that a normal LP does not constitute an “assignment” or a “transfer” of any “interest” (undivided or otherwise) in the underlying asset. Thus, while properly structured MPs are covered by the Regulation, it appears that LPs which involve no “transfer or assignment” do not qualify as a “participation” under this Regulation.

The creation of an MP clearly qualifies as a “participation” under the Regulation (and as a “securitization” if the entity holding the asset is a “special purpose entity”). The Regulation also clearly applies if a bank owns a properly created and acquired interest in a loan (e.g., a partial MP) and actually “assigns” or “transfers” that interest to a participant. An LP, however, which does not transfer or assign an asset cannot comply with the Regulation.

If, for purposes of argument, it was decided that the Regulation treats LPs as “participations,” the following additional “sale” issues would remain.

1. The Regulation only limits rights of the FDIC to disaffirm contracts under 12 USC 1821(e). It does not, therefore, deal with the ability of FDIC, as receiver for a lead bank, to subordinate and defeat the LP, or a portion thereof which relates to a setoff of deposits between the lead bank and the borrower. The likely result of subordination is that the participant collects nothing.
(2) Since LPs are not "sales" under applicable case law, failure of the participant to file a financing statement against the lead bank would appear to provide the FDIC with the ability to subordinate the entire participation. When an interest is acquired through an MP (or any other agreement by which the lead bank's assets are, in fact, assigned or transferred), the new UCC protects against subordination by creating a security interest and against common law setoff by a transfer or assignment of the loan.

Thus, nothing in banking regulation or state law affects the correctness of the analysis of the Court in Okura.

BTM ARGUMENT (5) Finally, could documents other than the participation agreement be relied upon to support BTM's claim? Answer: NO.

The Court found BTM, by selecting to purchase LPs, decided to "contract with another party . . . in order to do business indirectly with the Debtor." Judge Gallet, therefore, had no sympathy for BTM's choice:

"BTM and the Debtor, as sophisticated business entities, could have achieved a direct lending relationship by the terms of the agreement, but did not." *Id.* at 615.

Sophisticated parties benefit by cases that clearly distinguish sales of financial assets from participations which involve no assignment. In Frati Enterprises, the fact that a participation was not a transfer proved very helpful. It allowed a bank with no deposit relationship to assign a loan to a bank with a deposit relationship to create a setoff right. As long as the transferee bank remains collectible, the fact that participations are mere loans to the lead bank avoids loss in these cases.

The Court in Okura concluded its decision by characterizing BTM's arguments as follows:

"BTM's opposition to the Trustee's motion can be aptly summarized as a blunderbuss defense. Instead of identifying a single legal theory upon which to rely, BTM attempts to defeat the Trustee's motion by making a series of unconnected, non-compelling arguments. Apparently, BTM was hoping that by creating a veritable cloud of arguments and issues, the underlying weakness of its position would not be exposed. Once the essence of BTM's position was identified, and its spurious arguments cleared away, it was apparent that its position is untenable. Furthermore, given the sophisticated nature of the parties, it is not unfair, from a policy standpoint, to strictly construe the terms of a participation agreement and hold the parties to the bargain they
 struck. The Trustee’s motion, therefore, is granted in its entirety.”

Id.

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

Response:

Common law setoff is not considered in true sale analyses because it has no application when financial assets are transferred. Where an isolation opinion confirms that a “transfer or assignment” occurred with respect to the underlying asset (rather than the LP agreement), common law setoff rights do not remain with the transferor, because mutuality is severed.

The AITF which wrote audit guidance for legal opinions under Statements 125 and 140 was advised by the FASB staff that participations which do not isolate underlying assets are not sales under Statements 125 and 140. Common law setoff rights only arise as an issue when the underlying asset is not transferred. Since all qualifying transactions require a transfer, there is no need for, or consideration given to, the type of opinion to be rendered relating to setoff rights.

Since an actual transfer was required, moreover, disputes over the meaning of § 541(d) (the so-called “mortgage servicing” provision) were not important. The opinion called for by audit guidance only relates to whether assets are property of the estate of a transferor in bankruptcy. There was no need for more based on the way the AITF understood the FASB believed these standards were to be read.

If a lawyer is asked whether a participation that involves no associated transfer of the underlying asset places the underlying assets beyond the reach of a transferor, the answer would have to be “no”, based on all the precedents cited above. That’s because a transaction that does not assign the underlying asset does not constrain the owner from selling the asset (in or out of bankruptcy). The later sale transaction may give rise to a claim against the asset seller, but not a claim that defeats the subsequent buyer. Moreover, case law on participations allows the lead bank to modify the underlying assets because there is no transfer. Therefore, an LP does not transfer “control” to a participant.

3. “What additional information about setoff rights should the Board consider? For example,

a. Does a setoff right exist between the original debtor and the transferee?

b. Do setoff rights exist if an affiliate of the transferor has a liability to the obligor?”
Response:

a. In the case of an LP, there is no "transferee." So this question does not apply to those participations. If the obligation of the original debtor is actually transferred, however, and the transferee owes an obligation to the original debtor, a common law setoff right exists. That is explained in Frati Enterprises. The transferee (which became the lead bank) used common law setoff. The participant (which was the initial transferor but not a transferee) could not use setoff.

b. As noted in Frati Enterprises, the loan would need to be transferred (not by an LP, but by an actual transfer) to the affiliate for common law setoff to be available.

The proper concern of the FASB would seem to be whether an asset is "sold" in a particular transaction. Common law setoff rights, when retained, indicate that no sale has occurred. These issues should not be confused, however, with statutory or regulatory obligations of asset transferees to recognize claims which obligors have against transferors. Those are rights which, like warranty claims, move "with" the asset on a transfer. Common law setoff rights are cut off by transfer and, when retained, indicate that no transfer has occurred.

When accounts are assigned under the UCC, rights of account debtors under contracts creating the accounts survive the assignment. Unrelated claims also survive, but only those which arise before a notice of assignment is given to the account debtor. This was a statutory compromise that resulted in freedom to assign accounts notwithstanding obligors' restraints on transfer, but continued the recognition of legitimate counterclaims of obligors.

In addition, in consumer transactions a federal regulation overrides state laws that free assignees of drafts from recognizing defenses that obligors could assert against transferors of the draft. Like the UCC provision, this is equivalent to a warranty claim which survives transfer of goods. Common law setoff rights are always severed by a transfer.

Where a commercial obligor evidences a payment obligation by a negotiable promissory note, assignment or transfer of the note generally protects the transferee against claims which the obligor has against the transferor. This is known as the "holder-in-due-course" doctrine.

None of these variations on setoff rules, however, is significant to the Board's examination of whether a typical LP is a "sale" of any interest in the underlying financial asset. LPs are not sales, absent a concurrent transfer or assignment of the underlying financial asset. A participation merely creates a payment obligation (debt) of the lead bank to the participant. If it includes a grant of a security interest and that interest is properly perfected, the participant may hold a secured debt of the lead bank; otherwise the claim is unsecured and subordinate to all depositors, as discussed above. Even when secured, however, common law setoff can apply to reduce or eliminate the participant's claim.

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?"
Response:

As discussed above, common law setoff rights are always eliminated by a transfer. Common law setoff rights exist only to the extent of mutual debts between the debtor and transferee. It is often asserted that setoff rights can be waived or eliminated. There appears to be no statutory or common law prohibition against waiving setoff rights.

A waiver, however, does not change the law relating to participations. Even if a setoff right is "waived," the participation does not transfer the asset. As a result, the lead lender still controls the underlying asset and can, at will, convert the participant’s interest into cash by truly selling the asset to a third party or by accepting a setoff in lieu of other payments (a waiver does not preclude acceptance of a setoff, it denies one side, the underlying obligor, the right to require acceptance of the setoff).

Moreover, so long as the lead continues to “own” the underlying asset, it is difficult to contemplate circumstances where a court would say a debtor must “pay” the “gross” debt owed to the lead without allowing the debtor to claim a reduction based on an obligation owed by the lead to the debtor. Rules which govern court proceedings often require the parties to resolve existing and matured claims by netting them, so as to assure efficiency of justice. Thus, a “waiver” may not affect rights of setoff.

If the lead lender is in receivership or bankruptcy, and a participant has not secured its position by an assignment of the underlying asset, it is not clear whether a participant could assert the waiver if the lead lender did not object to setoff.

In the case of accounts under the UCC, where a statute gives the obligor a right to assert claims against the transferee, there are specific terms allowing a waiver. Such provisions are included in some receivables sale arrangements. Since those rights survive transfer but common law rights do not, the issues are very different. The federal rule which allows consumer claims against merchants to survive transfer of the consumer’s draft cannot be waived in advance.

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 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.”
Response:

This revised standard would raise concerns where assets are collectible only when the transferor performs some committed activity. The revisions, moreover, may create problems for normal financial asset sales by making certain “loan” transactions “sales” for GAAP.

Some lawyers may not fully understand limitations on “financial assets,” as used in accounting literature. Moreover, the question seeks to know what a lawyer does “not typically” consider. Opinions are limited to specific issues and analysis. Everything else is, therefore, “not” considered. So, this is a pretty broad request.

There are many “future flow” securitizations where the obligor’s liability is, in fact, dependent on future financial performance by the transferor. These should not, however, affect accounting for transactions in financial assets. Until the transferor performs its side of a future flow transaction, there exist no financial assets to sell.

As noted above, accounts sold are subject to future arising obligations of the transferor to the account debtor until notice is given. Depending on how the Board defines “financial performance,” those future claims could be an issue not previously considered. As a legal matter, the current receivable can be sold even though a future default by the transferor could generate claims which can be asserted against a transferee.

If “financial performance” relates only to a direct payment obligation of the transferor or its affiliates, future flow arrangements should not be a concern.

The suggested definition of isolation ignores rights to recover assets sold. That would mean any non-recourse secured debt might qualify for sale treatment merely by a change in the form of the contract and notwithstanding the fact that the non-recourse secured creditor’s rights could be restrained under the Bankruptcy Code or eliminated by setoff rights. A preclusion of rights to redeem or recover assets (as exists under SFAS 140) is a necessary addition to the Board’s standard to assure equal treatment of these transactions.

Very truly yours,

[Signature]

Frederick L. Feldkamp

Enclosures
Statement of Expertise

— Bank and securities lawyer since 1971.

— Draftsman (1973) of first post-Depression legal isolation opinion (relating to participations and transfers of mortgages) for a private mortgage-backed security.

Represented sellers under "repurchase agreements" in the first bankruptcy of a dealer in U.S. securities (1975), which established relative rights of parties to repurchase agreements.

— Represented banks in 1977 challenge of the authority to expand savings and loans into the business of banking, without legislative authority.

— Represented initial issuers of bonds backed by mortgage securities (1979).

— Drafted documents for first public offering of rated bonds backed by conventional (uncertificated) mortgages transferred to a bankruptcy-remote issuer (1981).

— Represented the issuer of the first private sector collateralized mortgage obligations (1983).


— Represented RTC, advisor on securitization to FDIC and purchasers of thrifts out of receivership during the "S&L Crisis" (1987-93).


— Council to issuers of initial offerings of securities backed by non-mortgage assets that brought "CMO" technology to non-mortgage debt markets (1992-1997).

— Negotiated and received SEC no-action letter that coincided with reversal of the "hedge fund" crisis of 1998.

— Legal advisor to AITF that established legal opinion guidance under SFAS 125 and 140, including presentations which concluded with FDIC's issuance of regulations allowing banks to conform with Statement 140.

— Author or co-author of:

"Who Let the Bears Kill Goldilocks?" Futures & Derivatives Law Report, July/August 2003 (Vol. 23, No. 5)


SYNOPSIS

Typical loan participations are structured so that there is no transfer or assignment of any interest in the underlying asset. They are unsecured loans from a participant to the lead lender.

Transfers and assignments of financial assets (for example, rated mortgage participations) permit lenders to allocate loan ownership to the lender with the most collateral from time to time. Differences between transactions that transfer assets and loan participations, therefore, create means to maximize recovery by setoff and collection. The lead lender is provided liquidity by borrowing from participants, who do not acquire any interest in the underlying loan.

If the lead lender on a typical loan participation is a bank that goes into receivership, the absence of a transfer or assignment of the underlying asset means that the lead lender’s depositors have priority rights to the underlying loan. Loan participants, having no interest in the underlying loan, are general creditors of the lead bank and, therefore, lose to depositors by specific setoff rights and the preference given to depositors under FIRREA.

Absence of a transfer or assignment means that a participant is not entitled to priority rights as to the underlying loan under the UCC or under the FDIC regulation on asset sales (12 CFR § 360.6).

Under the U.S. Bankruptcy Code, the absence of a transfer or assignment means that the participant holds no claim against the underlying loan obligor. As a creditor of the lead lender, however, authorities are split on a participant’s priority by virtue of 11 USC § 541(d).

Setoff rights flow to the entity which “owns” the underlying asset. In a typical participation, therefore, setoff rights exist only between the lead bank and the underlying loan obligor.