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TA&I Director – Setoff and Isolation
Financial Accounting Standards Board
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Re: Setoff and Isolation

Ladies and Gentlemen:

The Loan Syndications and Trading Association (the "LSTA") appreciates the opportunity to respond to the Request for Information dated April 9, 2004 (the "White Paper") of the staff of the Financial Accounting Standards Board (the "FASB" or the "Board"). The LSTA represents all segments of the nearly $1 trillion corporate loan market, including banks, broker-dealers, other buyers and sellers of corporate loans (including mutual funds and merchant banks) and professional financial service firms. As such, our response focuses almost exclusively on transfers of corporate loans pursuant to participation agreements, and not on transfers (whether by participation or otherwise) of other assets. We have attached as Annex B to this letter a list of specific activities relating to participations that would be significantly affected by changes to Statement 140's treatment of setoff and other defenses.

1 New issue syndicated loan volume in 2003, as reported by Loan Pricing Corporation.

2 Thus, the LSTA’s membership conducts new issuance and primary sales (including through participations), par/near par and distressed trading and bank institutional portfolio management. Attached hereto as Annex A is a complete list of the LSTA's members. The LSTA and its members are committed to advancing the public understanding of the corporate loan market and to serving the public interest by encouraging adherence to the highest ethical standards by all market participants and promoting the highest degree of confidence for investors in corporate loans. Additional information with respect to the LSTA is available at http://www.lsta.org.

3 Because we focus on loans to corporations, we do not address consumer laws, including for example, consumer laws that might affect the ability of an obligor to waive its setoff defenses. We understand that the American Securitization Forum is submitting a response to the White Paper that addresses sales of assets (other than loan participations) and includes a discussion of the effect of consumer laws on such sales. We support the American Securitization Forum's response.
Transfers of corporate loans often take the form of participations rather than assignments. In participations, the “lead” lender originates the underlying loans and sells interests in such loans to one or more participants. As set forth in some detail in Annex B, there are a number of reasons why corporate loans are sold in the form of participations, ranging from the inability to get borrower or agent consents, confidentiality considerations, relationship considerations, servicing considerations, and, especially in the context of smaller loans, cost considerations. The inability of institutions to sell participations and derecognize the portion of the loans participated could restrict credit availability generally, increase competitive inequalities for community institutions in particular and significantly limit the ability of institutions to manage and disperse credit risk.4

We wish at the outset to make clear that the LSTA believes that:

- under Statement 140 in its current form, properly-drafted loan participations are correctly viewed as sales;5
- market participants, rating agencies and investors are generally well aware of setoff defenses and incorporate their evaluation of the nature, probability and extent of such defenses in their rating analyses and investment and pricing decisions;
- the existence of setoff defenses should not preclude sales accounting;
- changing the implementation of the legal isolation standard in Statement 140 to take into account setoff defenses that may be more hypothetical than real6 would have a material and adverse impact on the manner in which market participants would be able to sell, participate or otherwise transfer corporate loans (and, therefore, if the Board does determine to change the implementation of Statement 140 in this regard, it should do so with a long transition period and on a prospective basis only);
- eliminating all setoff defenses is not possible in all circumstances;

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4 See, for example, letter from the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision and the National Credit Union Administration to Ms. Suzanne Q. Bielstein, Director of Major Projects and Technical Activities, Financial Accounting Standards Board (Dec. 1, 2003).

5 By a “properly-drafted participation” we mean a participation agreement that, among other things, evidences a clear intent by the transferor to sell a beneficial (or “equitable”) interest in the loan and does not have economic features (such as recourse) that would affect the conclusion that there has been a sale of a beneficial interest. In addition, we have assumed that a properly-drafted participation meets the requirements of Paragraph 106 of Statement 140 and that counsel could give a “true sale” opinion (as described below) with respect to the participation. (Indeed, some of our members have obtained true sale opinions in connection with loan participations.)

6 We note that there are no reported examples under the Federal Deposit Insurance Act (“FDIA”) of the exercise of setoff defenses by or against a failed bank in a manner that prejudiced a transferee since the Mademoiselle and Penn Square cases from the late 70’s and early 80’s (discussed below) – notwithstanding the large number of bank and S&L insolvencies in the mid-80’s and early 90’s. We are also not aware of any reported examples of the exercise of setoff defenses impairing a participant outside of the bank insolvency context.
• eliminating many setoff defenses may be possible, but may require, in the case of FDIC-insured institutions, FDIC comfort; and

• eliminating all bankruptcy risks to a purchaser of assets is an “absolute assurance” standard that is not achievable and will result in virtually no sales of any type of assets for purposes of Statement 140.

We have organized our response generally in the order of the questions posed in the White Paper (although we have answered Question 4 together with Question 1 in order to address setoff defenses and the elimination of such defenses as part of a single answer). We begin with a brief discussion of setoff defenses generally. Second, since our focus in this letter is participations (and most participations are sold by FDIC-insured institutions), we address obligor and transferor setoff defenses in the context of FDIC receivership proceedings. Third, we discuss setoff defenses in the context of proceedings under the Bankruptcy Code in respect of Bankruptcy Code-eligible transferors. Fourth, we respond generally to the Board’s request that we address setoff defenses with respect to transferors that are subject to receivership by other regulatory agencies. Here we include a detailed discussion of receivership proceedings under the New York Banking Law because many New York branches of foreign banks are frequent sellers of participations. Fifth, as requested in the White Paper, we apply our prior analysis to address whether specific forms of transfer could function to eliminate setoff defenses. We then respond to the Board’s questions 2, 3 and 5 in that order – specifically addressing whether setoff defenses are currently considered in true sale opinions, the existence of setoff defenses between the obligor and the transferee or an affiliate of the transferor and a discussion of the Board’s proposed revised isolation standard. Note that in the following discussion, when we refer to sales of participations we refer only to the initial sale of participations by the lead lender and do not address subsequent sales of participations or subparticipations by an initial or later participant.

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?

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?

A. Setoff Defenses Generally

The information about setoff defenses in the White Paper is generally accurate. We analyze in more detail below the relative rights of the obligor, the transferor and the transferee in a loan participation.

Setoff is a defense to payment by an obligor in respect of an obligation it owes to its creditor on account of a claim it has against that creditor. In the context of a loan, the obligor’s setoff defense is simply another available defense to the enforcement of the obligor’s obligations in respect of that loan. Setoff is generally available only when the obligations to be set off are held by the same parties acting in the same capacity. The common law defense of setoff is exercisable by either party in the event of default, insolvency, bankruptcy, or
receivership of the other party in respect of matured, non-contingent claims. That common law right applies to all enterprises and their counterparties.

"Setoff" defenses can be distinguished from "recoupment" defenses. "Setoff" defenses of the type generally described in the White Paper are defenses to payment not arising from the contract itself — the right of an obligor to not pay on a loan obligation because of a default by the creditor in payment of a deposit obligation being an example. "Recoupment" defenses are defenses arising from the contract itself — for example, the right of an obligor to not pay on a contract for the purchase of goods because the creditor did not fulfill its obligations under that contract.

We note that, in addition to common law defenses of setoff, there may be statutory defenses of setoff under state law. Also, the White Paper's discussion of setoff assumes that the parties have not contractually enhanced or waived their setoff defenses. We discuss both waivers and contractual setoff defenses below.

The discussion below is unusually complicated. This is because, while setoff in general is a common law defense, there is a complicated and often arcane set of statutory rules that — depending on the context — further enable or restrict the exercise of setoff defenses. This varying statutory treatment is a result of varying policy objectives. For example, as discussed below, certain statutory rules provide that in the case of "negotiable instruments", the simple transfer of such assets is sufficient to cut off obligor setoff defenses. In those cases, policy makers have determined that protection of buyers of such assets is the critical policy goal. Other statutory rules ensure that in certain cases obligors retain setoff defenses even in the context of sales of assets. In those cases, policy makers have determined that protecting obligors from losing certain defenses — absent notification to the obligor — simply because of a sale by the transferor is a critical policy goal. Other statutory rules ensure that if an asset contains transfer restrictions, those restrictions are not effective to restrict transfer, but are effective to preserve setoff defenses, even if notice is given.

The ability to preserve or restrict the exercise of setoff defenses is a critical tool of policy makers to achieve critical policy objectives, and is independent of the question of whether an asset has legally been sold. This critical tool, however, could be seriously compromised if significant variations in accounting treatment forced market participants to structure transactions in ways that would eliminate setoff defenses (to the extent possible) —

7 Other examples of "setoff" (as opposed to recoupment) defenses include the obligor's defense to payment on a loan from the transferor against claims against the transferor arising from: fraudulent activity unrelated to the loan; derivatives unrelated to the loan; breaches of contracts unrelated to the loan; and torts unrelated to the loan.

8 Section 9-404(a) of the New York Uniform Commercial Code (the "UCC") provides that a transferee of loans not evidenced by an instrument takes "...subject to (1) all terms of the agreement between the [obligor] and [transferor] and any defense or claim in recoupment arising from the transaction that gave rise to the contract; and (2) any other defense or claim of the [obligor] against the [transferor] which accrues before the [obligor] receives a notification of the assignment authenticated by the [transferor] or the [transferee]." "Setoff" defenses are those referred to in Section 9-404(a)(2), and "recoupment" defenses are those referred to in Section 9-404(a)(1). All references to state law in this letter are to New York state law, unless otherwise noted.

9 See, e.g., N.Y. Debtor and Creditor Law § 151.
potentially pulling out of balance the carefully crafted system of incentives and disincentives meant to direct behavior by policy makers.\textsuperscript{10}

\section*{B. FDIC-insured Institutions and Loan Participations}

The common law defense of setoff described by the Board in the context of loan participations is generally accurate for transferors subject to receivership by the FDIC, subject to certain qualifications discussed below.

1. \textbf{Obligor setoff defenses:} In the context of participations (as in the context of most other asset sales), the obligor will be able to exercise setoff defenses against the FDIC as receiver for the transferor.\textsuperscript{11}

Certain of the obligor's setoff defenses can be eliminated through various techniques, although the participation structure is not consistent with some of these techniques. Generally, obligor setoff defenses arising after a sale can be eliminated by the "negotiation" of a "negotiable instrument" to a "holder in due course"\textsuperscript{12} or, in the case of loan not evidenced by a "negotiable instrument", notification to the obligor pursuant to Section 9-404 of the UCC (unless the non-negotiable instrument loan asset contains transfer restrictions).\textsuperscript{13} Both of these methods are inconsistent with the participation structure, in which negotiable instruments, if they even exist as evidence of the loan asset, are not "negotiated" to the transferee, and in which notice is typically not given to the obligor.\textsuperscript{14} Even if notice were given to the obligor, transfer restrictions in the loan documentation might make such notice ineffective to cut off the obligor's setoff defenses.\textsuperscript{15}

\textsuperscript{10} We note, for example, in the letter sent to the FASB from the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision and the National Credit Union Administration and referred to in footnote 4 above, the signatories emphasized how a proposed change in accounting treatment could significantly affect the regulators' ability to achieve certain policy objectives - such as diversified portfolio management, credit availability and lending opportunities for small business financing. Letter from the Office of the Comptroller of the Currency et al. to Ms. Suzanne Q. Bielstein of 12/1/03.

The UCC construct - that an asset can be sold without notice to the obligor and even in the face of transfer restrictions - is one that is different from many civil law jurisdictions. The UCC construct allows securitizations and other non-notification transfers to occur in a manner that might not be possible under many civil law jurisdictions. It would be ironic that a change in the accounting rules would quash non-notification sales expressly contemplated by the UCC.

\textsuperscript{11} A transferor may represent to a transferee that the asset is free of these defenses. A transferee's claim for a breach of that representation would, however, only be an unsecured claim in a transferor bankruptcy or insolvency.

\textsuperscript{12} UCC § 3-202 requires that for a transferee to become a "holder", the negotiable instrument (which must be payable to order or to bearer and meet other technical requirements) must have been delivered with any necessary indorsement. Specific rules apply to determine what is an effective indorsement. A "holder in due course" is a holder that takes for value, in good faith and without notice of adverse claims or defenses. UCC § 3-302.

\textsuperscript{13} Section 9-404 is quoted in footnote 8 above. Although Section 9-404 of the UCC does not apply to a loan evidenced by an instrument, we believe that, in the case of a non-negotiable instrument, the same rule would apply. See, Restatement of the Law (Second) Contracts 2d § 336 (1981).

\textsuperscript{14} One of the purposes of the participation structure often is to allow a transferor to sell an interest in a loan asset while still maintaining its relationship with the obligor. For this reason, notice is not given to the obligor of the existence of the participation.

\textsuperscript{15} In addition to Section 9-404 of the UCC, Section 9-408 similarly functions to maintain obligor setoff defenses in certain circumstances. Section 9-408 applies to sales of payment intangibles or promissory notes and generally makes
We note, however, that "negotiation" of negotiable instruments and notice to obligors will not cut off all defenses. Even where "negotiable" instruments exist, "negotiation" thereof to a holder in due course would cut off most defenses, but not all defenses, of the obligor. In the large majority of cases, where "negotiable" instruments do not exist, notice to the obligor, even if feasible, would not cut off defenses of the obligor that had accrued prior to the notice (and, as stated above, transfer restrictions in the loan documentation might make notice ineffective to cut off any of the obligor's setoff defenses).

The loan documentation underlying many loans sold in the form of participations does, however, contain waivers by obligors of setoff defenses. These waivers would generally be enforceable under state law and would be effective to cut off setoff defenses of the obligor, even in the case of an FDIC proceeding in respect of the transferor. However, other financial arrangements between the obligors and transferees or non-bankruptcy remote affiliates of transferees (for example, swap master agreements or brokerage agreements) may affirmatively provide for setoff defenses between the parties. The interplay of the waivers in the loan documents and the affirmative grant of setoff defenses in other agreements would have to be examined on a case-by-case basis.

Whether a bank transferor could obtain a "would"-level legal opinion that obligor setoff defenses are eliminated by a transfer of an interest in an asset through a participation would thus depend principally on whether the loan documentation underlying such loans contained waivers of these defenses. Ironically, it would not be the transfer of the asset or mechanics in connection with the transfer that would cut off obligor setoff defenses, but instead ineffective restrictions on assignments. (A loan asset would typically either be a "promissory note" or, if not evidenced by a note, a "payment intangible" under the UCC.) For example, in the context of a loan agreement which contains an anti-assignment clause restricting the transferor from assigning or otherwise transferring the loan, Section 9-408(a) provides that the anti-assignment clause would be ineffective to prevent a sale. Pursuant to Section 9-408(c), however, the obligor would still retain its setoff defenses against the transferor (unless it had waived them; notice would be ineffective in this case to cut off the obligor's setoff defenses). The retention by the obligor of its setoff defenses does not affect the sale characterization of the loan. In fact, Section 9-318 of the UCC provides that "[a] debtor that has sold a payment intangible, or promissory note does not retain a legal or equitable interest in the [asset] sold." In other words, Section 9-408(c) prevents the elimination of the obligor's setoff defenses in cases where the UCC clearly contemplates the occurrence of a sale.

16 Although "negotiation" of a "negotiable instrument" to a holder in due course will serve to cut off most obligor defenses, it will not cut off so-called "real" defenses (infancy, incapacity, illegality, duress, and certain types of fraud).

17 The scope of such a waiver would be a case-by-case determination. In many instances of large corporate loans, obligors waive both setoff and recoupment defenses. In smaller loans, the loan documentation may not contain any waivers at all.

For an attorney to give a "would"-level opinion that such a waiver is enforceable, the attorney would need to make several factual assumptions, including the due authorization, execution and delivery by the obligor of the waiver, the sophistication of the obligor, that fair consideration was given to the obligor for the waiver and that the waiver was not given in satisfaction of an antecedent debt. In addition, waivers might not be enforceable to the extent they purport to waive an obligor's right in a bankruptcy of the obligor to offset amounts owing to a creditor against amounts owed by the creditor to the obligor in connection with an avoidance action (such as a preference recovery action).

Although we confine our analysis of state law to New York law, we note that the laws of non-U.S. jurisdictions that might be applicable (e.g., in the case of a non-U.S. borrower), may render the enforceability of a waiver of setoff or recoupment defenses uncertain.

Some of the Penn Square cases referred to below indicate that notice to the obligors was not relevant to the obligors' setoff defenses, without citing to the UCC. We believe that statements in the cases to this effect (none of which are critical to the holdings in the cases) were not correct.
the characteristics of the asset itself. In other words, the existence of obligor setoff defenses would be entirely independent of the sale of the asset.

2. **Transferor setoff defenses:** Although the White Paper does not specifically distinguish between obligor setoff defenses and transferor setoff defenses, much of the confusion in the area of participations and setoff defenses stems from the issue of transferor setoff defenses. This limited issue arises only when both the obligor and the transferor are in default. Pursuant to 12 U.S.C. § 1822(d), the FDIC “…may withhold payment of such portion of the insured deposit of any depositor in a depository institution in default as may be required to provide for the payment of any liability of such depositor to the depository institution in default or its receiver, which is not offset against a claim due from such depository institution….” The term “insured deposit” is defined in 12 U.S.C. § 1813(n) as “the net amount due to any depositor … for the deposits in an insured bank (after deducting offsets) less any part thereof which is in excess of $100,000.” In the context of loan participations, the FDIC indicated in a 1991 FDIC Interpretive Letter that it would require offset (pursuant to 12 U.S.C. Section 1822(d) above) only if an obligor’s debt is delinquent or has matured. 18 The FDIC has taken the position in the context of loan participations that “…at least insofar as the insured portion of a deposit is concerned, the FDIC’s statutory right of offset cannot be impaired by a waiver executed by the lead bank.”19 In other words, the FDIA (as interpreted by the FDIC and the Seattle-First case, discussed in footnote 21 below) provides that the FDIC as receiver may set off an obligor’s deposit against the amounts owed by the obligor in respect of a participated loan. Moreover, according to the FDIC, this is a statutory right of the FDIC as receiver that cannot be waived by the bank transferor, at least to the extent of $100,000 per obligor. We discuss below other laws that may affect this conclusion.

It is unclear whether 12 C.F.R. § 360.6 (adopted in 2000), has any effect on transferor setoff defenses. Essentially, 12 C.F.R. § 360.6 provides that, subject to certain qualifications, the FDIC will not use its powers to repudiate or disaffirm a contract to reclaim financial assets transferred by an insured depository institution in connection with a participation. Although this rule provides comfort that a participation is beyond the reach of the FDIC as receiver (as representative of creditors generally), it does not directly address setoff defenses of either the obligor or the transferor.

It is also unclear whether recent amendments to the UCC (in 2001) have any effect on transferor setoff defenses. Section 9-318 of the UCC provides that a transferor that...

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18 1991 FDIC Interp. Ltr. LEXIS 21 (Feb. 5, 1991) (“A borrower whose note has not matured may request an offset on the unmatured obligation owing to the failed bank…. The FDIC will require offset where the depositor’s debt is delinquent or has matured.”)

19 1984 FDIC Interp. Ltr. LEXIS 20 (Oct. 23, 1984) (“It is my opinion that, at least insofar as the insured portion of a deposit is concerned, the FDIC’s statutory right of offset cannot be impaired by a waiver executed by the lead bank.”). Note that typically, in the context of loan participations, a participant would prefer from a commercial perspective that the bank transferor retain its setoff defenses. This is particularly true where the participant views the bank transferor as more creditworthy than the underlying obligor. We also note that, during the revisions to Article 9 of the UCC, bank regulators strongly supported provisions protecting a bank’s setoff defenses with respect to deposit accounts.

It is unclear whether the FDIC would take the position that the FDIC’s statutory right of offset cannot be waived in the context of 100% loan participations. It is also unclear whether the FDIC would take this position if a waiver were structured so as only to affect the participant and not the bank transferor in the event of a default by the obligor. If the FDIC were to give comfort on these issues, whether counsel could render a “would”-level opinion that a participant would take free of transferor setoff defenses would depend on the nature and scope of FDIC comfort.
has "sold a ... payment intangible ... or promissory note does not retain a legal or equitable interest" in the transferred property. Section 9-318 could be viewed as bolstering the sale status of loan participations and therefore ensuring a break in mutuality between the transferor and the obligor sufficient to cut off transferor setoff defenses even in the light of the FDIA provisions. There are, however, arguments that Section 9-318 does not affect the inquiry as to transferor setoff defenses and, in any event, the argument that Section 9-318 applies in this context is untested.

The case law in the area is also quite unclear, as it often confuses obligor and transferor setoff defenses and is otherwise poorly reasoned.21

Because of this uncertainty, although counsel would be able to render a "would"-level legal opinion that a well-drafted participation is a sale of an interest in a loan, it would not likely be able to issue an opinion that the transferee takes free of transferor setoff defenses (even with a waiver by the transferor, at least in the absence of FDIC comfort on the issue).22

3. Transferee’s claim against receivership estate: Case law provides that the transferee would have an unsecured claim against the transferor for any amount set off by the obligor or the transferor.23 In accordance with this case law, the FDIC has provided in an interpretive letter that where the FDIC is appointed receiver for a transferor bank, the participant will receive its pro rata share of any payment made by the underlying obligor “which augments the receivership estate”. As the exercise of offset by the obligor against the transferor bank

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20 See UCC Section 9-109(d)(10).

21 Mademoiselle and the Penn Square cases constitute the most significant body of case law addressing, in the context of FDIC proceedings, the interplay between a depositor’s right of setoff and the rights of a loan participant. See FDIC v. Mademoiselle of Cal., 379 F.2d 660 (9th Cir. 1967); Chase Manhattan Bank v. FDIC, 554 F. Supp. 251 (W.D. Okl. 1983); Hibernia Nat’l Bank v. FDIC, 733 F.2d 1403 (10th Cir. 1984); Seattle-First Nat’l Bank v. FDIC, 619 F. Supp. 1351 (W.D. Okl. 1985); Northern Trust Co. v. FDIC, 619 F. Supp. 1340 (W.D. Okla. 1985) (the last four cases being the “Penn Square” cases). Although the Penn Square cases are not particularly well reasoned and are inconsistent with each other in a number of respects, in each case (with the possible exception of Seattle-First), they and Mademoiselle reach the same result regarding the obligor’s setoff defenses as would we under a UCC analysis – namely, that the obligor would be entitled to set off its obligations under a participated loan against amounts on deposit with the transferor absent waiver or notification. (Neither the Mademoiselle nor the Penn Square courts referred to the UCC for their analysis; it is not entirely clear why that is so.) As to transferor setoff defenses, Seattle-First is the most difficult case, as Seattle-First involved a well-drafted participation agreement (unlike in the other Penn Square cases) and most clearly dealt with transferor, as opposed to obligor, setoff defenses (although it looked to obligor setoff defenses in determining transferor setoff defenses). It is not clear that Seattle-First was properly decided at the time, and it is unclear whether new UCC § 9-318 or 12 C.F.R. § 360.6 would have influenced the Seattle-First court to come to a different conclusion.

22 We note that an FDIC attorney in a letter to the FASB staff indicated that a bank transferor of a participation continues to be a creditor of the obligor, entitled to enforce the loan, whereas the transferee is not a direct creditor of the obligor. George Miller, The Bond Market Association (Feb. 10, 2004) attaching a message from Robert F. Storch, Accounting and Securities Disclosure Section Chief/Chief Accountant. This is a hallmark of a participation, and the attorney’s conclusions are correct. But the absence of direct creditor status does not mean that, as between the bank transferor, its creditors generally and the transferee that the transferee does not own the interest in the loan the subject of the participation, nor does the attorney’s statement so state. Indeed, since as stated in the letter the FDIC passes through the proceeds of the loan due to the participant, it could only be because the transferee owns an interest in the loan. Unless the participant were an owner or a secured creditor with a perfected security interest (and, typically, transferees of participants do not take the steps necessary to perfect a security interest in a loan were the sale thereof recharacterized), the FDIC as receiver would not recognize the participant’s priority interest in the proceeds of the loan.

23 See e.g., FDIC v. Mademoiselle of Cal., 379 F.2d 660 (9th Cir. 1967).
C. Bankruptcy Code Transferors and Loan Participations

The description in the White Paper of common law setoff and the priority of a transferee’s claim against the transferor for the amount set off is generally accurate for transferors subject to the U.S. Bankruptcy Code (the “Code”), although the cases relating to the relative priority of transferees and obligors are mostly in the FDIC area (and as set forth above, those cases are relatively old and in many instances poorly reasoned).

1. Obligor setoff defenses: The Code recognition of common law setoff is codified in Section 553 of the Code. Section 553 provides that the defense of setoff is generally unaffected by a bankruptcy proceeding under the Code. Thus, even though a participation can be a sale of an interest in a loan asset, the obligor will be able to exercise setoff defenses against the bankrupt transferor or its trustee.

The analysis of how obligor setoff defenses may be eliminated is the same in the case of a Code transferor and an FDIC-insured transferor. Whether a Code transferor could obtain a “would”-level legal opinion that obligor setoff defenses are eliminated by a transfer of an interest in an asset through a participation would again depend principally on whether the loan documentation underlying such loans contained enforceable waivers of these defenses (as “negotiation” of any “negotiable instrument” or notice would not be consistent with a typical participation).

2. Transferor setoff defenses: The Code does not address transferor setoff defenses and we are not aware of any case law in that regard. In contrast to the FDIA, the Code does not provide a statutory right of offset that can be exercised by a bankrupt transferor or its trustee. Because the case law in respect of loan participations and transferor setoff defenses is

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25 The exercise by the obligor of setoff defenses is subject to the automatic stay under the Code. In addition, setoff will be disallowed to the extent that: (i) the obligor’s claim against the creditor is disallowed, (ii) the claim was transferred to the obligor post-petition or within 90 days of the petition date while the creditor was insolvent, (iii) the obligor acquired the claim within 90 days of the petition date, while the creditor was insolvent and for the purpose of obtaining a right of setoff against the creditor or (iv) the obligor exercised pre-petition setoff defenses and its position improved in the 90-day period.

26 Section 541(d) of the Code provides in pertinent part that:

Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest ... becomes property of the estate ... 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.

As set forth above, a “properly drafted” participation is one in which the beneficial or equitable interest in a loan is transferred, but legal title is not transferred. See e.g., In re Columbia Pac. Mortgage, Inc. 20 B.R. 259, 261 (Bankr. W.D. Wash. 1981) (Congress enacted Sec. 541(d) “in an obvious effort to eliminate the uncertainties developing in the national secondary mortgage market and to promote that market by protecting participation interests in loans from challenge in bankruptcy...”) and In re Coronet Capital Co., 142 B.R. 78, 80 (S.D.N.Y. 1992) (“The purpose of Section 541(d), as applied to the secondary mortgage market is to make certain that secondary mortgage market sales (like loan participation agreements), as they are currently structured, are not subject to challenge by bankruptcy trustees. Those purchasers of mortgages are able to obtain the mortgages or interests in mortgages that they have purchased from a debtor without a trustee asserting that the sale of the mortgage is a loan from the purchaser to the debtor.”).
under the FDIA and involves the FDIC’s statutory right of offset, and because of the
ambiguities in the case law and the recent enactment of Section 9-318 of revised Article 9, it is
unlikely in respect of Code transferors that transferor setoff defenses would survive the sale of
an interest in a loan pursuant to a well-drafted participation. It is not clear, however, that in the
absence of an express waiver, counsel could give a “would”-level opinion that a participation
would in and of itself cut off transferor setoff defenses.

If the Code transferor waived its setoff defenses, however, counsel might be able
to conclude to a “would”-level degree of certainty that transferor setoff defenses were cut off by
the participation. Such an opinion would assume, among other things, that the waiver was duly
authorized, executed and delivered, that the transferor was sophisticated, that fair consideration
was given for the waiver and that the waiver was not given in satisfaction of an antecedent
debt.27

3. Transferee’s claim against transferor’s estate: Although there do not appear
to be any cases, it would appear that the rule of Mademoiselle – that setoff does not result in an
augmentation of the estate traceable by a transferee – would also apply in Code proceedings.
Thus, a transferee would appear to have an unsecured claim against the transferor for any
amount set off by the obligor or the transferor.

D. Other Transferors and Loan Participations

We address one type of transferor that would not be subject to the FDIA and
might not be subject to the Code: non-FDIC insured New York State-licensed branches of non­
U.S. banks subject to the provisions of the New York Banking Law (the “NYBL”). We address
such branches because they are frequent sellers of loans pursuant to participations (often in
rated transactions).28 We do not address certain other transferors, such as broker-dealers that
are members of the Securities Investor Protection Corporation,29 insurance companies, credit
unions,30 and entirely non-U.S. entities31 that are likely not subject to the FDIA or the Code.

E. Non-FDIC-insured New York State-licensed Branches of non-US Banks

The NYBL, and not the FDIA, would apply to the liquidation of a non-FDIC-
insured New York State-licensed branch of a non-U.S. bank that does not also have a federally-
licensed branch (a “NY Branch”).

27 It is not clear what incentive a bankrupt transferor or its trustee would have to exercise setoff defenses against an
obligor, unless the obligor were more insolvent than the transferor, as the exercise of setoff defenses simply substitutes one
creditor for another. If the obligor were more insolvent than the transferor, the transferee would benefit from the transferor’s
exercise of offset defenses. The FDIC might have different incentives in the case of a bank transferor because of its role as
insurer and the preference afforded depositors over general unsecured creditors.

28 U.S. GAAP may, however, not be relevant to all such branches.

29 Such broker-dealers may be subject to liquidation under the Securities Investor Protection Act (“SIPA”), but are not
themselves active sellers of loan participations.

30 Insurance insolvency is a matter of the law of the state in which an insurance company is domiciled. The insolvently
of federally-insured credit unions is governed by the Federal Credit Union Act.

31 For example, a foreign subsidiary of a U.S. holding company might sell loan participations. The insolvency law
governing such a subsidiary would likely be non-U.S. law.
1. Generally: The NYBL in many respects treats a NY Branch as if it were a subsidiary of the home office of the bank, and not just a branch, and creates a so-called “ring-fence” around the assets of the branch (and the assets of the bank in New York) that are used to satisfy only unaffiliated creditors of the branch. The assets subject to the NYBL are referred to as “the business and property in this state” of the foreign bank.

The New York Banking Department issued a series of letters relating to the question of whether loans sold under participations in connection with issuances of collateralized loan obligations would be “business and property in this state”, and concluded that such loans would not be “business and property in this state”, and would thus not be available to satisfy general creditors. Those letters do not, however, address setoff rights.

2. Obligor setoff defenses: The NYBL recognizes setoff defenses, except to the extent an obligor seeks to offset an obligation to a NY Branch against an obligation of the home office or another branch of the bank. Thus, even though a participation can be a sale of an interest in a loan asset, the obligor will be able to exercise setoff defenses against the insolvent NY Branch or its receiver.

The analysis of how obligor setoff defenses may be eliminated is the same as in the case of a Code transferor and an FDIC-insured transferor. Whether a NY Branch transferor could obtain a “would”-level legal opinion that obligor setoff defenses are eliminated by a transfer of an interest in an asset through a participation would again depend principally on whether the underlying loan documentation contained waivers of these defenses (as “negotiation” of any “negotiable instrument” or notice would not be consistent with a typical participation).

3. Transferor setoff defenses: The NYBL does not address transferor setoff defenses and we are not aware of any case law in that regard. In contrast to the FDIA, the NYBL does not provide a statutory defense of offset that can be exercised by an insolvent NY Branch or its receiver. Because the case law in respect of loan participations and transferor

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32 Section 606(4) of the NYBL authorizes the Superintendent to take possession of a foreign banking corporation’s “business and property in this state” (NYBL § 606(4)) whenever it appears that such foreign banking corporation “(a) has violated any law; (b) is conducting its business in an unauthorized or unsafe manner; (c) is in an unsound or unsafe condition to transact its business; (d) cannot with safety and expediency continue business; (e) has an impairment of its capital; ...” as well as under certain other circumstances. NYBL § 606(1). Assets qualifying as “business and property in this state” under NYBL § 606(4) are subject to the delivery demand provisions of Section 615(2) of the NYBL and the automatic stay provisions of Section 619(1)(d) of the NYBL. We do not address in this letter the potential effect of non-U.S. law on the relative rights of obligors to, and transferees from, NY Branches.

33 “Business and property in this state” includes all property of the foreign banking corporation: (i) wherever situated, constituting part of the business of the New York branch and appearing on its books as such; and (ii) situated within New York State, whether or not constituting part of the business of the New York branch or so appearing on its books. NYB § 606(4)(c).

34 See, e.g., NYBL letter to Rogers & Wells LLP, dated March 18, 1999. The NYBL letters assume, among other things, that counsel to the NY Branch will deliver a “true sale” opinion to the rating agencies.

35 We are unaware of any case law addressing loan participations and a liquidation proceeding under the NYBL.

36 NYBL § 615.

37 New York Debtor and Creditor Law Section 151 generally gives an obligor setoff defenses upon the bankruptcy of its creditor, and an insolvent NY Branch and its receiver would have the benefit of this statutory setoff defense. However, there is no specific statutory setoff defense given a receiver of a NY Branch, and there is case law to the effect that the setoff defenses in
setoff defenses is under the FDIA and involves the FDIC's statutory right of offset, and because of the ambiguities in the case law and the recent enactment of Section 9-318 of revised Article 9, it is unlikely that transferor setoff defenses would survive the sale of an interest in a loan pursuant to a well-drafted participation in the event of a NYBL proceeding. It is not clear, however, in the absence of an express waiver, that counsel could give a "would"-level opinion that a participation would in and of itself cut off transferor setoff defenses.

If the NY Branch transferor waived its setoff defenses, however, counsel might be able to conclude to a "would"-level degree of certainty that transferor setoff defenses were cut off by the participation. Such an opinion would assume, among other things, that the waiver was duly authorized, executed and delivered, that the transferor was sophisticated, that fair consideration was given for the waiver and that the waiver was not given in satisfaction of an antecedent debt.\(^{38}\)

4. Transferee's claim against transferor's estate: Although there do not appear to be any cases, it would appear that the rule of Mademoiselle—that setoff does not result in an augmentation of the estate traceable by a transferee—would also apply in NYBL proceedings. Thus, a transferee would appear to have an unsecured claim against the NY Branch transferor for any amount set off by the obligor or the transferor.

*The White Paper specifically asks whether certain forms of transfer will eliminate setoff rights:*

We now apply the foregoing analysis to the specific forms of transfer:

*Sale of whole assets to a third party without any form of recourse.* Sale of a whole asset (as opposed to a participation) will not in and of itself affect obligor setoff defenses, unless the asset is a "negotiable instrument" "negotiated" to a "holder in due course". (Even then, not all defenses of the obligor will be eliminated.) If the asset is not such a "negotiable instrument", sale of the asset will not cut off obligor setoff defenses unless the obligor waives such defenses or the obligor is notified of the sale. However, even if the obligor is notified of the sale, such notice will not cut off setoff defenses that accrue prior to notification. Similarly, notification of the obligor will not cut off recoupment defenses and will not cut off any setoff defenses whatsoever if the asset contains transfer restrictions.

Sale of a whole asset might cut off transferor setoff defenses. As discussed above, participations might cut off transferor setoff defenses, but this is not entirely clear (especially for FDIC-insured transferors). Other forms of sales should cut off transferor setoff defenses.

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\(^{38}\) It is not clear what incentive an insolvent NY Branch transferor or its receiver would have to exercise setoff defenses against an obligor, unless the obligor were more insolvent than the transferor, as the exercise of setoff defenses simply substitutes one creditor for another. If the obligor were more insolvent than the transferor, the transferee would benefit from the transferor's exercise of offset defenses.
defenses, even in the case of FDIC-insured transferors, although we are aware of no case law on this point. 39

**Transfer of whole assets to a bankruptcy-remote SPE (in which the transferor holds the equity investment) or a qualifying SPE.** The analysis is the same as in the preceding example. The nature of the transferee is not relevant to the question of whether obligor or transferor setoff defenses are cut off by a transfer.

**Explicit waiver of setoff rights by the original debtor.** As discussed above, waiver of setoff defenses by an obligor will generally be enforceable to the extent of the waiver. 40

**Explicit waiver of setoff rights by both the original debtor and the transferor.** As discussed above, waiver of setoff defenses by an obligor will generally be enforceable to the extent of the waiver, and waiver by a transferor will (except, perhaps, in the case of an FDIC-insured transferor) generally be effective to cut off transferor setoff defenses to the extent of the waiver.

**Explicit contractual provision that the contract can be sold to a third party.** An explicit contractual provision that the contract can be sold to a third party does not by itself cut off obligor setoff defenses. Absent an obligor's explicit waiver of setoff defenses, an obligor will retain setoff defenses with respect to freely assignable loans unless such loans are represented by "negotiable instruments" and are properly "negotiated" or the obligor is given notice of the transfer – neither scenario is applicable in the context of loan participations. Furthermore, even when an obligor is notified of the transfer, such notice does not cut off recoupment defenses, or setoff defenses that accrue prior to notification.

**Notification to the original debtor that the transferor has sold the debt to a third party.** Notice will cut off setoff defenses that accrue after notification, but will not cut off recoupment defenses, or setoff defenses that accrue prior to notification. Notice will not cut off setoff defenses for certain assets with transfer restrictions.

**The transfer is documented in an assignment agreement that includes approval by the obligor.** Assignment agreements are typically used for the sale of loans where the underlying loan documentation already contains obligor waivers of setoff defenses. Where the underlying loan documentation does not already contain obligor waivers of setoff defenses, an assignment agreement executed by the obligor that contains waivers of obligor setoff defenses would normally be effective to waive such defenses. The typical assignment agreement will cut off all transferor setoff defenses.

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39 In addition, it may not always be clear whether, in the absence of a waiver by a transferor (and any other relevant parties), contractual provisions specifically giving a transferor (and its affiliates) setoff defenses would be cut off by a sale of the asset.

40 As noted above, we do not address consumer laws that may affect the ability of an obligor to waive setoff defenses or non-U.S. law that, if applicable, may render the enforceability of a waiver uncertain.
2. **How are rights of setoff currently considered in true sale analyses performed by attorneys? If they are not considered, why not?**

Attorneys do not consider obligor or transferor setoff defenses relevant to the question of whether the assets have been legally sold or are beyond the reach of a transferor's creditors generally. While some practitioners specifically carve out setoff defenses from their true sale opinions simply as a warning to the transferee that it may take subject to setoff defenses, many do not because they do not believe that those defenses are relevant to the question of whether an asset has been "truly sold". True sale opinions address whether assets have been sold or, instead, pledged, and thus whether they are beyond the reach of the transferor's creditors generally; the answer to that inquiry determines whether the assets could be considered property of the transferor's bankruptcy or insolvency estate subject to the claims of creditors of the transferor generally. Whether the assets could be considered property of the transferor's estate determines whether the transferee of those assets would be able to exercise ownership rights over the assets in the event of the transferor's bankruptcy. If an asset is pledged and not sold, the "purchaser's" exercise of rights over the assets is not only subject to the automatic stay (in the case of the Code), but also limited to the value of the obligation "secured" - i.e., the "purchaser" as secured party would not gain from the asset's upside potential. Furthermore, in general, for a secured party to have a priority claim in an asset, it has to have "perfected" its security interest. Thus, the question of whether an asset has been legally sold, or instead pledged, can take on great significance.

Setoff defenses, on the other hand, do not involve the body of creditors generally, but instead only a single creditor - the obligor - and the defenses of or against that single creditor are not relevant to the question of whether an asset has been sold or pledged. Indeed, Section 9-404 of the UCC illustrates this quite clearly. Under 9-404, obligor setoff defenses are statutorily protected to ensure that an obligor retains such defenses even if an asset is sold (absent waiver or notification). Section 9-408 of the UCC is another example of a specific statutory provision meant to ensure that an obligor retains setoff defenses even if an asset is in fact sold. Obligor setoff defenses are simply not relevant to the question of whether an asset has legally been sold. Transferor setoff defenses (to they extent they survive a transfer) are also not relevant to whether a transfer is a sale or a pledge. We are aware of no cases in which the existence or non-existence of setoff defenses was relevant to a court's determination of whether a transfer was a sale or a pledge.

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42 Attorneys do not give ‘legal isolation’ opinions. Even if that rubric were one known to the law, as discussed below in the response to Question 5, attorneys cannot opine that all transferor-related insolvency risks are eliminated in any sale.

43 Indeed, many true sale cases are brought because the transferee has not taken the steps necessary to perfect a security interest in the asset purportedly sold to it.

44 See footnote 8 above.

45 See footnote 15 above.

46 See Seattle-First, 619 F. Supp. at 1357 ("The Court concludes as a matter of law that the challenged offsets [by the FDIC] were proper, notwithstanding any property or trust interests conveyed to Seafirst, because mutuality between the transferor [and the obligors] survived the participation agreement."). (Emphasis added.)
The White Paper states that “[i]f the setoff rights are not eliminated by the transfer, the transferred financial asset is not isolated from the transferor as required by Statement 140.” (Emphasis added.) This statement seems to mean that the Board takes the view that the legal isolation standard is broader than the question of “true sale” (i.e., whether an asset has been sold or whether it has been pledged to secure a liability), and also encompasses the question of whether the transferee is subject to setoff defenses in respect of the sold asset. (And see Question 5 below for the response to the even broader standard proposed in the White Paper.) Although the Board is of course entitled to come to this conclusion, lawyers, rating agencies and the markets generally view setoff risk (and the other risks addressed in Question 5 below) as insolvency risks that are independent of whether an asset has legally been sold.47 Because of the apparent different understandings of the legal isolation standard, we view the Board’s proposal that legal isolation includes isolation from setoff defenses as a change in the standard or, at least, a change in the implementation of the standard.

In the context of loan participations, as discussed above, attorneys asked to address setoff defenses will not be able to opine that all setoff defenses have been eliminated in all circumstances. If the loan asset contains enforceable waivers of obligor setoff defenses,48 and if the participation agreement contains enforceable waivers of transferor setoff defenses (which would not appear to be possible under current FDIC interpretations, at least to the extent of $100,000 per obligor), then counsel could give such an opinion. To require such waivers would, in the LSTA’s view, be changing market practice and commercial expectations for the sake of an accounting concern that may well be more hypothetical than real. To engage market participants in discussions with the FDIC regarding a $100,000 per obligor setoff right that will only be exercised if both the transferor and the obligor are in default would likely be a time-consuming effort for little practical benefit. If the Board nevertheless insists that Statement 140 should be interpreted to require the elimination of all setoff defenses, then the LSTA requests that there be a transition period so that market participants can obtain the appropriate waivers and obtain such changes in law or interpretation from the FDIC as are necessary for counsel to give “would”-level opinions, and that such change of interpretation be applied only prospectively. As set forth above, however, even after a transition period, it might not be possible to obtain the requisite comfort in many cases. Again, the LSTA believes that the possible impact of such an accounting change on the important market in loan participations could be severe, and that the risk of setoff defenses does not justify such an accounting change.

3. **What additional information about setoff rights should the Board consider? For example, does a setoff right exist between the original debtor and the transferee?**

Setoff defenses (unless waived) would exist between the obligor and the transferee in the case of a “negotiable instrument” transferred to a holder, and for non-negotiable instruments where notice of the transfer has been given to the obligor. Whether setoff defenses exist between the obligor and the transferee in other circumstances is not entirely clear. In the case of participations, a transferee does not have a setoff defense against

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48 Again, for most U.S. borrowers in most circumstances, such waivers would be enforceable. There may, however, be issues with waivers by non-U.S. borrowers.
the obligor unless contractually provided for. We have not found any cases involving other
"non-notification" sales of assets that address the question of whether the transferee or obligor
have setoff defenses with respect to one another.

**Do setoff rights exist if an affiliate of the transferor has a liability to the obligor?**

Generally setoff defenses would not exist if an affiliate of the transferor has a
liability to the obligor because the requirement of mutuality as to the parties is strictly
construed. However, to the extent the transferor and the transferor’s affiliate could be
consolidated in bankruptcy or insolvency, such a consolidation could conceivably create
mutuality sufficient to support setoff defenses between such affiliate of the transferor and the
obligor. Consolidation should not occur with respect to a bankruptcy remote special purpose
entity. Furthermore, in certain circumstances, multiple parties may enter into agreements
entitling some or all of the parties to set off obligations to some or all of the parties against
obligations from some or all of the parties. These agreements may or may not be enforceable.

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.

The definition of legal isolation proposed in Question 5 would be a fundamental
and radical change from the standard generally viewed as the current standard required by
Statement 140 and would require unobtainable “absolute assurances”. This broadened
definition of isolation would encompass a variety of factors, other than setoff defenses, that are
not typically considered by attorneys in rendering true sale opinions. This is because this
proposed definition of isolation - by focusing on the financial performance of the transferor -
has a fundamentally different focus than the focus in a true sale opinion. As discussed in the
response to Question 2 above, the focus of a true sale opinion is whether the assets have been
sold rather than pledged. The revised definition of isolation proposed in this Question 5 instead
fundamentally changes the analysis by asking not whether the assets have been sold or pledged
but rather whether the value of the transferred assets “depend[s] on the financial performance of
the transferor” or “is ... affected by bankruptcy, receivership, or changes in the creditworthiness

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50 The courts in Yale Express and Okura both found that because the loan participant in those cases did not have a direct
to sue the obligor, they could not set off obligations owing to the obligor against the loan obligations of the obligor. Yale
Express did not address the question of whether the transferor had sold an interest in the loan, but only whether the participant
could directly enforce the loan. Although Okura stated in dicta that the participation in question did not constitute a partial
assignment, it also indicated that it was not addressing whether the participant had an ownership interest in the loan proceeds,
but only whether the participant had a direct claim against the obligor. Also, as discussed above, UCC 9-408 (which became
effective after both Yale Express and Okura were decided) makes clear that, in the context of loans containing transfer
restrictions, such restrictions are not enforceable to prevent a sale, but are effective to prevent direct enforcement by the
transferee.
of the transferor.” As the discussion below demonstrates, we are concerned that no sale of an asset could meet this standard, and do not believe that the Board would intend such a result.

There are a number of credit-related issues with sales of assets that do not affect whether an asset has legally been sold.

**Recoupment defenses.** As described above, recoupment is a defense where the opposing claims arise from the same transaction. Absent a waiver, defenses in recoupment cannot be cut off in the case of non-negotiable instruments – even by notice to the obligor. So-called “real” defenses (incapacity, duress, certain types of fraud) cannot be cut off in the case of negotiable instruments. Obligors often do not waive recoupment defenses. Even though a transferor typically represents that there are no recoupment defenses, a breach of that representation will give rise to only an unsecured claim in its insolvency.

True sale opinions do not address recoupment defenses, as they are not relevant to whether an asset has legally been sold or is beyond the reach of creditors generally.

**Representation and Warranty Risks.** In addition to representations and warranties by a transferor that an asset is not subject to recoupment defenses, transferors often make representations and warranties as to the status of an asset (e.g., that a loan has a certain unpaid balance, a certain interest rate, the borrower is of a certain type and the collateral for the loan is of a certain type). The transferee of the asset (and subsequent transferees) may rely on these representations and the creditworthiness of the transferor in valuing the asset. The insolvency of the transferor may make these representations worthless and affect the market value of the asset.

Representation and warranty risk is not relevant to the question of “true sale”, and is not (and could not be) covered by legal opinions.

**Fraudulent Conveyance and Preference Avoidance.** Transfers for less than fair value, and transfers in satisfaction of antecedent debt, can be avoided in certain circumstances relating to the insolvency of the transferor. True sale opinions either do not address these points, or assume the factual basis (e.g., fair value and not insolvent) that renders the points moot.

**Servicing Risks.** Although we understand that the Board does not believe that servicing risk is encompassed within Statement 140, transferees from transferors that continue to service the sold asset face a number of insolvency-related risks.

**Delay Risk.** The serviced asset may decline in value and the transferee may not be able to obtain possession in order to sell the asset or better service the asset due to the insolvency of the transferor. This is a particular risk in the case of participations (where the transferor is a sort of “permanent” servicer).

**Commingling Risk.** A transferee’s claim for collections on serviced assets that are commingled with the transferor’s own funds at the time of its insolvency may simply be an unsecured claim against the transferor. Although the transferee owns the funds, its inability to trace them places it at risk.
Fraud Risk. The transferor could fraudulently sell the serviced loan asset to a third party that would in certain circumstances have priority over the original transferee.

Negligent Servicing. Negligent servicing may affect the value of an asset. A claim of the transferee against the servicer would be an unsecured claim in the servicer’s insolvency.

True sale opinions do not address delay risk, commingling risk, fraud risk or negligent servicing risk because these risks are not relevant to the question of whether a transfer is a sale or a pledge, or whether the asset is subject to the claims of creditors generally. Note that delay risk and commingling risk are directly correlated to the insolvency of the transferor, and that fraud risk and negligent servicing risk may be positively correlated to the insolvency of the transferor.

Conclusion

We acknowledge that our response letter is highly technical. However, our approach was guided by our view that the FASB staff and the Board would most appreciate detailed responses to the questions posed in the White Paper. We hope our approach has served to give the Board insight into the technical complexity and uncertainty of much of the analysis of setoff defenses. We would like to make the following “high-level” points in conclusion:

- The last twenty years prove that the existence of setoff defenses is a largely theoretical problem with few practical effects.

- Eliminating many obligor setoff defenses may be possible, but often quite impracticable. Not all obligor setoff defenses or recoupment defenses can normally be eliminated (and this may be particularly true in the case of non-U.S. obligors), so if the Board decides that setoff defenses are not consistent with sales accounting, it will need to articulate which defenses are acceptable and which are not — if none are acceptable, there will be very few accounting sales of financial assets.

- Eliminating transferor setoff defenses may only be possible under current law in the case of Code and NY Branch transferors. In the case of FDIC-insured institutions, a waiver may be effective, but not to the extent of $100,000 per obligor (according to an FDIC interpretation). The issue of transferor setoff defenses seems especially remote, as it only arises if both the transferor and the obligor are in default. For such a remote risk to change accounting for participations in a manner that could have a material and adverse impact on lenders and their borrowers does not seem justified.

- The LSTA believes that market participants have in good faith implemented what they believed to be the standard required by Statement 140 and further believes that no change should be made to this standard in the case of properly-drafted participations. If, however, the Board decides to provide that Statement 140 requires that setoff defenses be eliminated, it should apply...
this change on a prospective basis only and should provide for a lengthy transition period.

- The LSTA believes that the proposal that Statement 140 be amended to provide that a transferee not be subject to any risk arising from a transferor’s insolvency would be a fundamental and radical change. Again, if the Board decides to depart from the current standard, as currently implemented, it will have to distinguish between what are acceptable risks and what are unacceptable risks. If no risks are acceptable, it would result in there being virtually no accounting sales of financial assets.

- The LSTA believes that the current standard under Statement 140—a standard that requires a “true sale” opinion assessing whether property has legally been sold, rather than pledged—is a standard that makes appropriate and logical distinctions for derecognition purposes. The LSTA urges the Board to retain that standard. If the Board believes that setoff or other risks need to be reflected on financial statements, the LSTA would encourage the Board to find other ways to reflect those risks, rather than preventing derecognition.

We thank the Board for the opportunity to respond to the White Paper. We also request that our counsel, Seth Grosshandler of Cleary, Gottlieb, Steen & Hamilton, be invited to participate in the round-table discussions scheduled for May 25, 2004 and June 17, 2004. The issues involved in the White Paper are of extreme importance to the LSTA’s membership and we would be happy to discuss any aspect of this letter with you. Please do not hesitate to contact Allison A. Taylor, the LSTA’s Executive Director (at 646-637-9176 or by e-mail at ataylor@lsta.org) if you have any questions regarding this letter.

Very truly yours,

The Loan Syndications and Trading Association

By: [Signature]
Allison A. Taylor
Executive Director
ANNEX A

LIST OF LSTA MEMBERS AS OF MAY 2004

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Fleet BankBoston
General Electric Capital Corporation
Key Bank
Morgan Stanley
Natexis Banques Populaires
National Australia Group
Royal Bank of Scotland, The
Sumitomo Mitsui Banking Corporation
UFJ Bank Limited
Washington Mutual Bank
Westdeutsche Landesbank Girozentrale

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Affiliate Law Firm
Andrews & Kurth LLP
Ballard Spahr Andrews & Ingersoll, LLP
Bingham McCutchen LLP
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Buchanan Ingersoll PC
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Chapman and Cutler
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Cliffor...
ANNEX B

List of Affected Activities

The following have been identified as business activities that would be significantly affected should the Board adopt its current proposals that would curtail sales accounting treatment for loan participations in circumstances in which there are setoff defenses between the obligor and the transferor.

1. **Secondary Market Transactions in Syndicated Loans** – where outright assignment cannot be accomplished, transfer of ownership by sale of a participation interest is commonly used.

2. **Swinglines.** Credit exposure to borrowers by “swingline” lenders is dispersed by the purchase of participations by the other lenders in the syndicate for the duration of the swingline loan. Swingline loans are short-term loans (typically in the range of 5 days) made by a single lender in the syndicate. They can be repaid and re-borrowed, but if unpaid at the end of the intended duration, the other members of the syndicate fund under their revolving loan commitments to share ratably in the swingline lender’s exposure.

3. **Letters of Credit (1)** – Primary syndications of revolving credit loan facilities containing letter of credit subfacilities. There are typically one or a few lenders that issue letters of credit for the borrower’s account, and the other revolving credit lenders in the syndicate purchase risk participations from the Issuing Bank of the letters of credit. If there is a drawing under a participated letter of credit, and the borrower does not reimburse the Issuing Bank, the other lenders are required to fund their pro rata share of the drawn amount. In some agreements, the lenders then have a direct right of repayment of such amounts from the Borrower as part of its revolving loan obligations, but other agreements may not be structured in that manner.

4. **Letters of Credit (2)** - Primary syndications of syndicated letter of credit facilities involving a fronting bank or single letter of credit issuer. This involves a similar risk participation structure to item 3 and similar requirement for funding by the participating banks if the borrower does not reimburse the Issuing Bank.

5. **U.S. Gov’t Guaranteed Obligations (Primary)** – Primary syndications of certain U.S. government supported financings (such as syndicated government receivable financings). The facility may be structured with a single lender having direct rights against and recourse to the government. The risk is then distributed to other financial institutions through participations.

6. **U.S. Gov’t Guaranteed Obligations (Secondary)** - Secondary market participations of U.S. government guaranteed or insured emerging market paper. For example, U.S. Eximbank-guaranteed loans are often made by a single lender because Eximbank wants to deal with a single entity as to guarantee claims and administration of the loans. The lender then sells participations in the secondary market to distribute its risk.

7. **Trade Finance** - Secondary market participations of trade finance obligations. The risk of certain funded trade obligations (acceptance financing or trade loans) and bilateral letter of

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credit arrangements (the risk of the account party or issuing bank reimbursement) is often distributed by means of participations.

8. **Emerging Markets** — a significant portion of emerging markets debt, especially sovereign debt, is comprised of loans. As a consequence of the fact that borrower consent to assignment is rare, a very large proportion of trading activity in emerging market sovereign debt is by the sale of loan participations.

9. **Syndications customarily achieved through participation:**
   a. Construction loans
   b. SBA loans
   c. Loans originated by community/smaller banks
   d. Loans to individuals