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TA&I Director - Setoff and Isolation
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Financial Accounting Standards Board
401 Merritt 7
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Re: FASB Staff Request for Information re: Setoff and Isolation

Dear Ladies and Gentlemen,

The Commercial Mortgage Securities Association (the "CMSA") is pleased to have the opportunity to respond to your Request for Information regarding Setoff and Isolation dated April 9, 2004. The CMSA is the international trade organization for the commercial real estate capital markets, whose mission is to improve the liquidity of commercial real estate debt through access to the capital markets. The CMSA is comprised of over 295 members, representing more than 3,000 professionals. Our members represent all aspects of the commercial and multifamily mortgage backed securities ("CMBS") industry including commercial banks, investment banks, insurance companies, conduit loan originators, warehouse and portfolio lenders, transferors of real estate loans and securities into CMBS transactions, purchasers of all classes of CMBS and parties acting as master servicers and special servicers for CMBS transactions. Our members are also active in the origination, purchase, sale and servicing of commercial and multifamily real estate loans, many of which are ultimately transferred into CMBS transactions.

The CMBS market creates significant liquidity for both the U.S. and international commercial and multifamily real estate markets. CMBS industry analysts estimate global CMBS outstanding at more than \$450 billion, with U.S. CMBS constituting more than \$400 billion of that number.

You have requested information about setoff rights as well as any other factors or conditions affecting isolation of transferred assets that you may not be aware of in the context of your project to amend FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. Your request explains that the Board is considering "defining isolation of financial assets from a transferor 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. If transferred financial assets are isolated from the transferor, the value of those assets to the transferee will depend solely on the financial performance of the issuer of the original transferred assets (the original debtor)." You express concern that true sale opinions given by attorneys in connection with sales of financial assets do not include setoff rights in the list of issues considered to determine whether a transfer is a sale for legal purposes and that accountants rely on true sale opinions when determining that the assets have been isolated beyond the reach of the transferor and its creditors for purposes of financial derecognition under FAS 140. You request information regarding a series of questions relating to setoff and the definition of isolation under FAS 140.

We appreciate the Board's decision to request information and to sponsor a roundtable to explore how the law of setoff and other factors may affect isolation issues under FAS 140 prior to issuing a new exposure draft regarding possible amendments to FAS 140. We are aware that a number of industry trade organizations, law firms, financial institutions and their regulators are responding to your request for information. In particular, we have reviewed responses being provided to you by the Loan Syndications and Trading Association and by the American Securitization Forum, which discuss the law of setoff in considerable detail. We believe the discussion contained in such submissions is accurate, we support their submissions and we do not intend to repeat their substance here.

We thought it would be helpful to you for us to:

- explain how the issue of setoff is dealt with in the context of sales of commercial mortgage loans,
- make suggestions regarding how the setoff issue might be considered and disclosed in making a determination whether a transfer of financial assets meets the isolation criteria under FAS 140 for purposes of derecognition by the transferor, and
- voice our concern that if the Board decides to change the definition of isolation for purposes of FAS 140 by requiring that the value of assets in the hands of the transferee not depend on the financial performance of the transferor and not be affected by bankruptcy, receivership or changes in the creditworthiness of the transferor, this change will be impractical to implement, will have a seriously negative impact on liquidity in the mortgage market and will lead to misleading financial statements of both transferors and transferees.

Setoff in the Context of Sales of Commercial Mortgage Loans

Commercial mortgage loans are generally originated as whole loans by a single lender or as syndicated loans with multiple notes (*pari-passu* or senior/subordinated) issued to separate lenders secured by the same real estate collateral. In a syndicated commercial mortgage loan origination, although each lender holds its own note,¹ title to the real estate collateral is generally held in the name of a trustee, custodian or the lead lender/servicer for the benefit of the noteholders. Occasionally commercial mortgage loans are originated as whole loans with the originator/transferor then selling a *pari-passu*, senior or subordinate participation interest in the loan.

When commercial mortgage loans are securitized, legal title to the loans is transferred to a bankruptcy remote special purpose entity (a "SPE", which term includes a qualifying SPE under FAS 140 or "QSPE") in a one step or two-step transfer. The transferor may receive one or more interests in the commercial mortgage loans or in the transferee thereof as part of the consideration for the sale and may act as a servicer. If the loan is to be derecognized by the transferor under FAS 140, the ultimate transferee must be a QSPE and the transaction must otherwise comply with FAS 140. If a participation interest is transferred to a SPE in a CMBS transaction, typically legal title to the loan is also transferred to the SPE, which agrees to hold legal title for itself (as holder of a participation interest in the loan) as well as for the holder of the participation interest that has not been transferred to the SPE.²

Commercial mortgage loans or participation interests in commercial mortgage loans may also be sold by one institution to another. Whether a loan or a participation interest is sold to a SPE, a QSPE or to another financial institution, the borrower may not be informed of the sale except when servicing is transferred. Commercial mortgage loan documents generally include an acknowledgment by the borrower that all or a portion of the mortgage loan may be sold or securitized without requiring borrower consent or notice to the borrower. In fact, commercial mortgage loans are generally transferable without the consent of, or notice to, the borrower even if the documents are silent.

¹ Commercial mortgage notes, although transferable instruments, may or may not meet the definition of a "negotiable instrument" for purposes of Article 3 of the Uniform Commercial Code. Section 3-104(1)(b) requires that an instrument "contain an unconditional promise or order to pay a sum certain in money and no other promise, order, obligation or power given by the maker or drawer except as authorized by this Article". Although Section 3-112 authorizes certain other provisions to be included in an instrument without affecting its status as a "negotiable instrument", a commercial mortgage note may include additional provisions which results in it not constituting a negotiable instrument for purposes of Article 3 of the UCC.

² It is possible that legal title to the loan will not be transferred to the SPE in the event that the other participation interest was previously securitized, in which case legal title to the loan would have been transferred to the SPE holding the participation interest in the previous securitization.

Buyers of commercial mortgage loans are fully aware that setoff and other common law borrower defenses may affect the value of the loans they buy. These are ordinary course of business risks that buyers evaluate when buying any financial asset. Although the risk of borrower setoff is generally eliminated by borrower waivers of setoff in the mortgage loan documents and the risk of transferor setoff is generally eliminated by transfer of legal title to the loan to a SPE in a CMBS transaction, other borrower defenses to payment such as usury can have an even greater impact on value since they may void the whole loan and a borrower waiver of the defense of usury may not be enforceable as a matter of public policy, and certain borrower defenses, such as fraudulent inducement, survive the sale of the loan even to a holder in due course of a negotiable instrument.

a. Protection Against Setoff Risks

To deal with setoff and other risks, commercial mortgage loan documents typically include a waiver of setoff defenses³ and waivers of other similar common law defenses by the borrower. In addition, the purchase and sale agreement usually includes numerous representations and warranties by the transferor regarding the status of the loans at the time of sale and the transferor's origination and servicing practices with respect thereto prior to sale, including a representation that none of the loans being sold is subject to any right of rescission, setoff, valid counterclaim or other defense. The transferee of the loans has the right to require the transferor to repurchase a loan if there is a breach of a representation and warranty relating to such loan, which has a material adverse effect on its value.

The sale of a commercial mortgage loan cuts off the transferor's ability to set off against the borrower.⁴ Thereafter the risk of setoff applies with respect to mutual debts owed between the borrower and the transferee, although as noted earlier, the borrower generally waives its right of setoff in the mortgage loan documents. If the commercial mortgage loan is sold to a SPE (whether it is a QSPE or simply a bankruptcy remote SPE), there should be no risk of setoff by the transferee because the SPE is not permitted to have debts to the borrower. A SPE's purposes are limited to owning the commercial mortgage loans and its other assets, the SPE is not permitted to have any debt other than the CMBS it issues and short term trade debt necessary to carry on its operations (such as fees owed lawyers and accountants) and the SPE is required to comply with a variety of separateness covenants to ensure that it will not be consolidated into the bankruptcy of any of its affiliates. A similar analysis should apply in a typical CMBS structure in which a participation interest in a commercial mortgage loan as well as legal title to the commercial mortgage loan is transferred to a SPE.

³ Waivers of setoff defenses by borrowers are generally enforceable in the context of commercial, non-consumer financial assets under U. S. law, including commercial mortgage loan transactions. Opinions specifically addressing this point are not obtained.

⁴ Even when the transferor retains servicing and title to the real estate collateral documentation for servicing purposes, in such capacity it becomes an agent or independent contractor of the transferee and the setoff risk is eliminated because in order to exercise setoff, two parties must owe mutual debts to each other in the same capacity, i.e., as principals to each other.

b. True Sale and Substantive Nonconsolidation Opinions

True sale opinions are required by the rating agencies for rated CMBS transactions and are also generally required by buyers in commercial mortgage loan sales and CMBS transactions which are not rated when the transferor retains a subordinated interest in the loans or in the SPE transferee, or a transferor may require such an opinion when the transferor intends to derecognize the transferred financial assets under FAS 140.

Lawyers rendering true sale opinions analyze the structure of the transaction against a series of common law factors developed by case law over the years primarily dealing with the intention of the parties, the economic risks and rewards of the transaction (including recourse) and certain other factors to distinguish whether the transaction is a sale or financing.⁵ Setoff and other common law borrower defenses do not alter the true sale opinion analysis of whether, as between the transferor and the transferee, the asset has been sold or financed, since borrower defenses are not included as relevant factors in the applicable case law. Survival of borrower defenses is an ordinary risk in the sale of assets and is not relevant to the issue of whether the relationship between the transferor and transferee is that of seller to buyer or of debtor to creditor. After analyzing the transactions against the case law factors, lawyers rendering true sale opinions reach the conclusion that in a properly presented case, a true sale has occurred for legal purposes and, as a result, the financial assets, which have been sold, are not part of the estate of the transferor in its bankruptcy or insolvency. This principle is recognized not only under the common law, but also by statute under the Bankruptcy Code and by the FDIC.⁶

Substantive nonconsolidation opinions are required by rating agencies when the transferee is an affiliate of the transferor or one of its affiliates. These opinions involve the analysis of case law relating to the issue of whether in bankruptcy the transferee and its assets would be equitably consolidated into the bankruptcy of the transferor or any of its affiliates having a role in the transaction. SPE's are required to comply with numerous separateness covenants to protect against this risk. These opinions involve an analysis of the bankruptcy case law factors relating to this issue and of the separateness covenants applicable to the transferee included in the operative documents for the transaction and in the transferee's organizational documents. The opinions also rely on certain factual representations by the transferor and transferee and on factual assumptions the lawyer is permitted to make in the opinion. Lawyers rendering substantive nonconsolidation opinions generally are required to reach the conclusion

⁵ The same factors and analytical process are applied whether the assets being sold are whole loans or partial interests in loans, including participations.

⁶ See Section 541(d) of the Bankruptcy Code ("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...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") and sec 12 CFR Section 360.6(b) ("The FDIC shall not, by exercise or its authority to disaffirm or repudiate contracts...reclaim, recover, or recharacterize as property of the institution or the receivership any financial assets transferred by an insured depository institution in connection with a securitization or participation, provided that such transfer meets all conditions for sale accounting treatment under generally accepted accounting principles, other than the "legal isolation" condition as it applies to institutions for which the FDIC may be appointed as conservator or receiver which is addressed by this section."). Insurance company insolvency is regulated by the insurance commissioner for the state in which the insolvent insurance company is organized. Insurance insolvency law generally looks to state common law and any relevant state statutes with respect to setoff issues.

that in a properly presented case, the transferee of the loans would not be consolidated into the bankruptcy of the transferor or its other affiliates having a role in the transaction.

In both true sale and substantive consolidation opinions, counsel not only relies on representations and warranties made in the documents and in certificates delivered in connection with the opinion and makes certain factual assumptions, but also reviews the major operative documents and the structure of the transaction and compares and weighs them against the legal factors analyzed in the opinions. In contrast, the issue of whether a common law right of setoff exists, and whether it could possibly affect the value of the transferred asset in the hands of the transferee, is primarily a factual question which depends (i) on whether the borrower has waived setoff in the loan documents, (ii) whether the transferor has waived setoff in the transaction documents, (iii) if the transferor hasn't waived setoff, (or if it is a bank and if such waiver is not enforceable against the FDIC), then whether the transferor (in a participation) or the transferee (in a whole loan purchase) has, or in the future may have, mutual debts between itself and the borrower, and (iv) whether circumstances will exist in the future giving rise to the ability to exercise any such setoff right or defense. All of these are factual issues, some of which are dependent on future events, which are best handled by representations and warranties by the parties to the transaction and analysis by the buyer of the materiality of these risks to the value of the assets in its decision to buy and the price to be paid.

c. Special Issues Relating To Participations

As mentioned earlier in this letter, the CMSA supports the positions advocated by the Loan Syndications and Trading Association relating to participations and we believe that a properly drafted participation agreement should permit the transferor of a participation interest to derecognize the financial asset so transferred.

In CMBS transactions, we also note that (i) commercial mortgage loans typically contain enforceable waivers of borrower setoff rights, (ii) even in situations where no borrower waiver of setoff exists, since commercial mortgage notes are instruments (and frequently qualify as negotiable instruments for UCC purposes) which are issued in a commercial context, many of the statutory provisions protecting borrower and consumer setoff defenses in transfers of other types of financial assets do not apply to transfers of commercial mortgage loans, and (iii) the risk of transferor setoff is *de minimis* since legal title to the commercial mortgage loans is transferred to a SPE (including in CMBS transactions involving the transfer of participation interests).

d. Summary

Commercial mortgage industry participants have viewed the isolation language in paragraph 9(a) of FAS 140 that the transferred assets have been put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership, as being satisfied if the assets are not part of the transferor's estate in the event of its bankruptcy or insolvency and if there is reasonable assurance that the QSPE into which they are transferred will not be consolidated with the transferor or any of its affiliates in the event of the bankruptcy thereof. The existence or survival of setoff defenses after a transfer has no effect on either issue, are ordinary course of business risks in any sale of assets and are *de minimis* risks in CMBS transactions.

Proposals for Consideration of Setoff for Purposes of the Isolation Criteria under FAS 140

CMSA believes that setoff is almost always a *de minimis* risk for commercial mortgage loan and CMBS transactions which investors are fully aware of and already protect themselves against since (i) borrowers typically waive setoff, (ii) transferors provide representations and warranties that no setoff defenses exist, and (iii) transfer of legal title to the mortgage loans should eliminate the transferor's setoff rights. Even in the circumstance in which a participation interest is sold, CMSA believes that setoff risks are minimal in CMBS transactions.

As noted earlier, there are many risks inherent in a loan sale that could affect the value of the loan such as usury, fraudulent inducement or other unlawful loan origination activities. In CMBS transactions these risks are covered by representations and warranties of the transferor, coupled with the transferor's repurchase obligation if breached. These risks primarily relate to facts, which the transferor is in the best position to know. It is impossible to opine over all of these risks through legal opinions and since they are so fact specific, the attorneys rendering the opinions must rely on representations from the transferor as to the accuracy of the factual predicates to the opinion, the same as a transferee who relies on transferor representations and warranties in the sale documents.

In addition, knowledgeable members of CMSA are not aware of any instance in which a commercial mortgage loan or participation interest in a loan has been repurchased by a transferor as a result of a breach of the customary representation and warranty related to setoff.

Under these circumstances, CMSA does not see a need to clarify the isolation criteria under FAS 140. CMSA strongly believes that to have the *de minimis* risk of setoff control whether a financial asset appears as an asset on the financial statements of the transferor instead of the financial statements of the transferee, when the financial asset is not part of the estate of the transferor in it bankruptcy or insolvency but is owned by the transferee, would be to truly have the tail wag the dog and result in misleading financial statements for both parties.

Change in this Definition of Isolation from a "Legal Isolation" Model to a "No Effect on Value of the Transferred Assets" Model

CMSA is very concerned that the approach being considered by the Board to define "isolation of financial assets from a transferor 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" when taken to its logical extreme is unworkable and would have a serious negative impact on the mortgage market. Whenever a transferor has ongoing obligations with respect to sold assets, whether to repurchase financial assets if representations and warranties made by the seller prove to be materially inaccurate or as servicer or administrator of the financial assets for the benefit of the owners thereof, the future financial condition of the transferor is relevant to its ability to be able to perform such obligations.

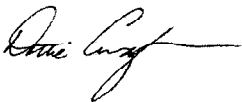
Even if such a standard were to carve out these sorts of customary "performance obligations", CMSA believes that such a standard is overly broad. It could easily lead to the unfortunate circumstance in which a minimal risk (such as the setoff risk), which buyers of financial assets are aware of and can protect against and value, which might occur if the transferor became bankrupt or insolvent, may cause accountants to treat transactions as financings on the financial statements of the parties involved even though for bankruptcy and insolvency purposes and other legal purposes such transactions are treated as sales. This would result in misleading presentations of financial statements to investors.

CMSA views the risk of setoff in CMBS transactions as being adequately covered by transferor representations and warranties and, in that regard, no different than numerous other risks covered by such representations and warranties. A requirement to eliminate all such risks (and/or to get legal opinions that these risks do not exist) is unworkable and could lead to the inability of sellers of financial assets to derecognize them and remove sold assets from their financial statements.

Conclusion

CMSA would be happy to provide one of its law firm members as a participant for FASB's roundtable on the topic of Setoff and Isolation. We hope this letter has assisted the Board in its understanding of how our industry deals with this topic. Because we view the risk of setoff as a minimal issue which buyers of financial assets are aware of, can protect against and value, we do not believe there is a need to change the current isolation standards included in paragraph 9(a) of FAS 140 as a result of this issue.

Very truly yours,



Dottie Cunningham
Chief Executive Officer