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May 10, 2004

# Via E-Mail

Mark R. Wada

Brian R. Witt\*

Financial Accounting Standards Board ATTN: TA&I Director – Setoff and Isolation P.O. Box 5116

Norwalk, CT 06856-5116

Re:

Letter of Comment No:
File Reference: 1200-SRI
Date Received: 5/11/04

Setoff and Isolation - Statement No. 140

#### Ladies and Gentlemen:

This firm represents Arrowhead Credit Union. Arrowhead is a federally-insured financial services cooperative chartered by the State of California and located in San Bernardino, California. We write on behalf of the Credit Union in response to your April 9, 2004 request for information in order to provide specific information pertaining to credit unions. We will not attempt to respond to all of the questions or address all of the issues raised in the request.

### Distinguishing Credit Union Share Accounts from Deposits

The Board has discussed 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 the bankruptcy, receivership, or changes in the creditworthiness of the transferor. The Board is concerned that an obligor's right to setoff loan obligations against uninsured deposits in a liquidation of the originating lender might affect the value of a participating lender's interest in loans originated by the financial institution in liquidation. In analyzing the impact of offset rights, it is important to distinguish among various types of accounts offered by financial institutions. In particular, the Board should distinguish between share accounts offered by credit unions and deposit accounts offered by credit unions and other financial institutions.

Credit unions are cooperative organizations, owned by their members. Federal credit unions (chartered under the Federal Credit Union Act, 12 U.S.C. § 1751, et seq.) and credit unions chartered in many states (including California) offer members "share" accounts instead of (or sometimes in addition to) deposit accounts offered by other financial institutions. A member's share account(s) evidences the member's ownership interest in the credit union.

#### FARLEIGH WADA & WITT PC

Financial Accounting Standards Board May 10, 2004 Page 2

The distinction between shares and deposits is an important element in the application of the FASB 140 principles to loan participations originated by credit unions. A credit union member's shares represent equity rather than credit. In the liquidation of a federally-insured credit union, this is significant. Pursuant to 12 C.F.R. § 709.5, general unsecured creditors received priority over shareholders with respect to distribution of credit union assets. In other words, a credit union member who holds share accounts stands in a different position that an owner of a deposit account. A depositor receives the same pro rata distribution as other creditors. A shareholder is entitled to pro rata distribution of what is left after payments to creditors.

This feature of credit union share accounts impacts the borrower's ability to set off loan obligations against uninsured shares in a liquidation setting. In order to exercise a right of setoff, there must be a mutuality of obligation between the parties. See, e.g., Advance Industrial Finance Co. v. Western Equities, 173 Cal.App.2d 420, 427, 343 P.2d 408 (1959). When a credit union member holds a share account, treated as equity in the event of a liquidation, there is no mutuality of obligation between the credit union member and the credit union. It would, therefore, be impermissible for a borrower to exercise a right of offset of the loan obligation against a share account in the liquidation context. We believe that any changes to FASB Statement 140 should address this difference between deposit accounts and share accounts. The Statement should permit true sale treatment for loan participations originated by credit unions that do not offer deposit accounts.

## Elimination of Offset Rights

If the Board redefines isolation of financial assets as contemplated, a credit union offering deposit accounts would need to satisfactorily address the setoff issue in order to achieve true sale treatment of a loan participation. The Board listed several techniques for eliminating setoff rights in the request for information. Some of these techniques would resolve the setoff issue, although certain techniques may be less desirable than others from a business strategy perspective. It would appear that a transfer of the entire loan to a third party without recourse (whether to an unrelated third party or a special purpose entity) could eliminate the right of setoff. Absent a waiver by the debtor of its setoff rights, a whole asset transfer would likely require notice to the original debtor in order to effectively eliminate the debtor's setoff rights. (See Uniform Commercial Code § 9-404.) An explicit waiver of setoff rights by the original debtor would likely be effective if adequately drafted.

# FARLEIGH WADA & WITT PC

Financial Accounting Standards Board May 10, 2004 Page 3

## Conclusion

If the Board intends to define isolation as discussed in the request for information, the Board should recognize that setoff rights will not impact true sale treatment of loan participations for credit unions offering share accounts. To the extent that credit unions (and other financial institutions) offer deposit accounts, the Statement should not require any particular method of dealing with the setoff rights, but should leave such analysis to individual financial institutions and their professional advisors.

Sincerely,

Harold B. Scoggins, III

HBS/jlb

cc: Arrowhead Credit Union