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Ms. Susan M. Cosper Technical Director Financial Accounting Standards Board 401 Merrit 7 PO Box 5116 Norwalk, CT 06856

Comments on Proposed Accounting Standards Update: Transfers and Servicing (Topic 860) – Effective Control for Transfers with Forward Agreements to Repurchase Assets and Accounting for Repurchase Financings (File Reference No. 2013-210)

Dear Ms. Cosper:

The purpose of this letter is to provide my comments on the Financial Accounting Standards Board's Exposure Draft Effective Control for Transfers with Forward Agreements to Repurchase Assets and Accounting for Repurchase Financings (File Reference No. 2013-210) (the "ED"). I am a Certified Public Accountant with nearly 25 years of professional experience with a significant emphasis on the accounting for financial instruments and structured transactions. My comments in this letter are largely based upon my experience having reviewed numerous legal opinions in support of the legal isolation criteria under Topic 860, Transfers and Servicing, as well as conversations with legal counsel from a number of different law firms.

I am generally supportive of accounting for repurchase agreements as secured financings, as I believe that the substance of such transactions is consistent with that accounting model. However, based upon my experience applying the de-recognition criteria, I believe that the control model as currently articulated in Topic 860 is fundamentally flawed. In my view, there is no question that this is a topic ripe for reconsideration. I fully support the Board adding a project to its agenda to fundamentally reconsider this topic.

The remainder of my comments address the legal isolation criteria as articulated in the Basis for Conclusions to the ED. I believe that the Board's comments are inconsistent with a plain reading of ASC 860 and will serve to add more confusion to a complex area.

Paragraph 860-10-40-5 states that "The transferred financial assets have been isolated from the transferor – put presumptively beyond the reach of the transferor and its creditors, even in

bankruptcy or other receivership." This statement has not changed in over 17 years since Statement 125 was introduced in 1996. A plain reading of that sentence requires that the transferred financial assets be legally isolated from the transferor at all times, including both outside bankruptcy (i.e, the normal course of business) and inside bankruptcy (i.e, even in the event of the bankruptcy of the transferor). (If this dual requirement were not present the sentence would not read "even in" it would read "only in".) This distinction matters because the laws governing legal isolation can differ depending upon whether the question of legal isolation is being decided by a bankruptcy court or a non-bankruptcy court.

In addition, articulating the legal isolation requirements as pertaining to both outside and inside of bankruptcy, rather than by reference to the term "true sale" (as discussed further below), facilitates the legal isolation analysis when a transaction is governed by foreign law, as some foreign jurisdictions rely entirely on statutory rules to make such determinations rather than on the common law concept of a true sale.

## True Sale and Legal Isolation in Bankruptcy

ASC paragraph 860-10-55-18A states: "In the context of U.S. bankruptcy laws a true sale opinion is an attorney's conclusion that the transferred financial assets have been sold and are beyond the reach of the transferor's creditors and that a court would conclude that the transferred financial assets would not be included in the transferor's bankruptcy estate." While this statement is not per say inaccurate, it narrowly applies the use of a true sale opinion to the bankruptcy context. However, a true sale opinion may be needed to support legal isolation outside bankruptcy.

It is important to note that the term "true sale" has no specific meaning in statutory law. In fact, many attorneys refuse to use the specific term "true sale" in their opinions. It is a convention used to refer to a legal analysis to determine whether a purported sale of an asset should be respected as a sale or treated as a loan/secured financing. In the absence of specific statutory rules, this analysis is typically undertaken using common law principles that focus significantly on whether or not the transferor has retained excessive recourse. If the transaction is deemed a secured financing rather than a sale, the transferee's rights are limited to those of a secured creditor without retaining any beneficial interest in the economic residual of the transferred assets over any amounts financed. This conclusion can be relevant outside of bankruptcy if one of the parties to the contract challenges the validity of the

contract terms. For example, a transferor may subsequently attempt to reclaim the residual on the assets by asserting that the assets were transferred as collateral rather than in a sale.

In the United States, a true sale analysis is based upon state contract law (including the relevant application of common law principles) – not federal bankruptcy law - because it is state law that governs contract law. In other words, a true sale analysis is relevant to certain aspects of the validity of the sale contract (i.e., whether or not it is a sale). In fact, one of the most commonly cited cases in true sale analyses is *Major's Furniture Mart, Inc. V. Castle Credit Corporation, Inc.* That case did not involve the bankruptcy of either party nor was the decision rendered by a bankruptcy court. (While many true sale questions are decided by bankruptcy courts, as explained further below, those decisions are based on applicable state law.)

A true sale analysis is relevant in the U.S. federal bankruptcy context because a bankruptcy court is required to decide certain transactional questions based upon the state law that governs the transaction in question. So if the estate of a transferor is attempting to repudiate a prior transfer contract and reclaim the transferred assets for the benefit of the estate's creditors (thus making the transferee a creditor of the transferor rather than an owner of the transferred assets), a bankruptcy court must decide the issue based on the state law applicable to the transfer contract.

AU Section 9336 provides a model two part opinion for entities subject to the U.S. Bankruptcy Code, as follows: "We believe (or it is our opinion) that in a properly presented and argued case, as a legal matter, in the event the Seller were to become a Debtor, the transfer of the Financial Assets from the Seller to the Purchaser would be considered to be a sale (or a true sale) of the Financial Assets from the Seller to the Purchaser and not a loan and, accordingly, the Financial Assets and the proceeds thereof transferred to the Purchaser by the Seller in accordance with the Purchase Agreement would not be deemed to be property of the Seller's estate for purposes of [the relevant sections] of the U.S. Bankruptcy Code." So a typical legal isolation opinion in the U.S. "kills two birds with one stone" – there is a true sale opinion based on state law (addresses the outside bankruptcy question, although it is rendered based on how a federal bankruptcy court would interpret state law) and that true sale analysis holds for bankruptcy proceedings (inside bankruptcy context).

However, the requirement for a bankruptcy court to apply state law to transactional questions that arise in bankruptcy only applies to the extent that federal law does not pre-empt state law in the bankruptcy context.

The U.S. Bankruptcy Code contains safe harbours for certain, but not all, repurchase agreements. If the code requirements are met then the transferred assets are legally isolated from the bankruptcy estate of the transferor<sup>1</sup>. This is true regardless of whether or not the transfer qualifies as a sale under applicable state law. However, the U.S. Bankruptcy Code cannot be relied upon outside a bankruptcy context to determine whether the purported sale would in fact be respected as such. An attorney would still need to perform a true sale analysis based on the applicable state law to reach such a conclusion. Therefore, where a transaction is potentially within a safe harbour under the U.S. Bankruptcy Code, two legal conclusions must be made to meet the criteria in ASC 860: (i) a conclusion that the transaction is in fact within the safe harbours of the U.S. Bankruptcy Code and (ii) that the transfer would be deemed a sale under the applicable state law.

## **Basis for Conclusions in ED**

Paragraph BC24 states: "The Board understands that in practice true sale opinions are not obtained for the majority of typical repurchase agreements for a variety of reasons, including the nature of the financial assets transferred, the existence of safe harbours in the U.S. Bankruptcy Code, and the presumption that a true sale opinion could be obtained if sought." The fact that legal opinions may not have been sought in practice when in fact they should have should not be informing the Board's understanding of what are the requirements for legal isolation.

Many attorneys are unwilling to issue a sale opinion under state law for repurchase transactions. For example, in the case of Lehman Brother's Repo 105 structure, Lehman was unable to obtain a true sale opinion to support the legal isolation criteria for repurchase agreements. (Whether this was due to the specific nuances of Repo 105 is not clear; however, Lehman's accounting policy stated as late as 2008 that: "Repos generally cannot be treated as

The asset is legally isolated in that the transferor cannot control the asset, as the transferee has the right to sell the asset in liquidation of the transferor's defaulted obligation to repurchase the asset; however, it is interesting to note that under section 559 of the Bankruptcy Code, the transferor must return to the transferee's estate any excess of the proceeds of the liquidation of the assets over the repurchase price. The transferor would have a claim against the transferee for any deficiency between the repurchase price and the sale liquidation proceeds. So the transferor has retained substantially all of the risks and rewards of the asset, but not control.

sales in the United States because lawyers cannot provide a true sale opinion under U.S. law."<sup>2</sup>) In addition, the former FASB Chairman Robert Herz wrote to Congress that: "In the United States, case law related to repurchase transactions has been varied enough that most attorneys generally would not provide a true sale analysis."<sup>3</sup> However, this statement is contradicted by paragraph BC4 of the ED which states: "Historically, for typical repurchase agreements and securities lending transactions, the Board understood that the conditions in items (a) [legal isolation] and (b) above would be met ..."

Paragraph BC25 states: "The Board observed that it would appear that obtaining a true sale opinion would be appropriate in circumstances in which the financial assets transferred fall outside the security types that are subject to the safe harbours provided in the U.S. bankruptcy Code and when different jurisdictions are involved." The implication of this statement is that obtaining a "true sale" opinion is not necessary when the financial assets transferred fall within the safe harbour. For the reasons discussed above, a true sale analysis would still be necessary to establish legal isolation outside bankruptcy. In addition, statements such as "appear" in regards to whether a legal criteria has been met do not belong in accounting standards.

In addition, paragraph BC26 which quotes from the American Law Institute does not belong in an accounting standard. The fact that entities may have relied on this paragraph to conclude that consulting a legal professional was not necessary provides even further reason why the Board should avoid making blanket legal conclusions in the standards.

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The basis for conclusions is undermining the Board's own requirement that legal isolation be demonstrated both inside and outside of bankruptcy. There is no need for the extended discussion in the basis for conclusions that appears to be misstating the actual legal analysis required under ASC 860. In addition, the AICPA is currently evaluating the need to update the existing guidance on the use of legal opinions as audit evidence. The FASB should not create confusion as to what is required under ASC 860.

Lehman Brothers Holdings Inc. Accounting Policy Manual, Lehman Examiner's Report, LBEX-DOCID 3213203

<sup>&</sup>lt;sup>3</sup> Letter to House Financial Services Committee dated April 19, 2010 from Robrt Herz, FASB Chairman

I recommend that paragraphs BC23 – BC27 be deleted in their entirety from the final Accounting Standards Update.