



May 10, 2004

TA&I Director  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, Connecticut 06856-5116

Re: Setoff and Isolation

Ladies and Gentlemen:

The American Securitization Forum<sup>1</sup> thanks the Financial Accounting Standards Board for this opportunity to comment on setoff and legal isolation.

We have responded below to each of the questions for respondents in the FASB Staff Request for Information dated April 9, 2004. Before proceeding with those responses, we believe it will be useful for us to state our general orientation towards these issues.

As the Board has recognized, the Board's initial reaction to the relationship between setoff rights and derecognition of financial assets is inconsistent with the general legal view concerning the relationship between setoff rights and true sale. Because GAAP and legal principles can diverge, the Board is entitled to take this approach. However, we hope that the Board will reconsider its approach once the Board has reviewed this and other submissions that explain more about the reasons for the general legal view and the details of the right of setoff. We strongly believe that both principles and practicality support a conclusion that the potential for setoff on account of liabilities owed by a transferor to the obligor on a transferred financial asset should not preclude derecognition.

*Principles.* The law recognizes some important circumstances where an obligor whose payable is assigned should retain some or all of the defenses that the obligor could have exercised against the original creditor. Here are two of the most important examples:

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<sup>1</sup> The American Securitization Forum (the "ASF") is a broadly-based professional forum of participants in the U.S. securitization market. Among other roles, the ASF members act as issuers, underwriters, dealers, investors, servicers and professional advisors working on securitization transactions. The ASF is an adjunct forum of The Bond Market Association. The views expressed in this letter are based upon input received from a broad range of ASF members including members of the ASF Accounting and Tax Subcommittee. More information about the ASF, its members and activities may be found at its internet website, located at [www.americansecuritization.com](http://www.americansecuritization.com).

- For decades, a rule of the Federal Trade Commission<sup>2</sup> (the “FTC Rule”) has required every consumer credit contract (for instance, retail automobile installment loans) to include a legend to the effect that any purchaser of the contract is subject to all claims and defenses which the debtor could assert against the seller of the goods financed under the contract. This is to assure that consumers are not deprived of important defenses relating to payments owed on defective goods merely because their initial creditor sells the contract.
- The Uniform Commercial Code<sup>3</sup> (the “UCC”) provides that a buyer of many common types of receivables (for instance, credit card receivables, short term trade receivables and lease receivables) may be subject to all defenses or claims of the debtor against the seller. If the debtor is notified of the sale, then some defenses and claims that arise *after* the notice is received are cut off. Even after the debtor receives notice, however, the buyer ordinarily remains subject to all defenses arising directly from the transaction in which the receivable arose, as well as other defenses that accrued prior to notice. The only way to eliminate these defenses and claims that survive notification is if the debtor waives them.

Notwithstanding these risks, buyers are willing to purchase these types of assets. For instance, most retail auto installment paper is originated by auto dealers, who assign the paper to a finance company or bank. The finance company or bank may in turn transfer the paper into a securitization. The FTC and UCC rules about setoff are the same for both the initial purchase from the auto dealer and any subsequent transfer into a securitization.

Banks and finance companies that buy this paper analyze potential setoff risks as analogous to other ordinary course seller risks that a buyer of any asset takes. Examples for non-financial assets are (a) risks as to the quality of goods that are sold with warranties that are worthless if the seller is unable to pay or perform and (b) risks of environmental hazards on real estate. As with these other risks, the law looks at setoff risk not as affecting the question of whether or not an asset has been sold, but rather as affecting the value or nature of what was sold. Buyers obtain warranties from sellers covering these risks, but they do not think of themselves as lenders to the sellers.

The law looks at property, whether financial assets or real estate, using a “bundle of sticks” approach. If an asset is like of a bundle of sticks, how many of the sticks does a purported buyer have to acquire in order to be respected as the true owner of the whole asset? Financial assets are particularly susceptible to being split up into separate “sticks.” From the bundle of sticks perspective, potential setoff risk is generally quite a small twig. It would be very strange if normal commercial transactions where every part of the bundle had been transferred other than that little twig could not achieve GAAP derecognition.

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<sup>2</sup> 16 C.F.R. § 433.2. This goes beyond setoff and also permits the obligor to affirmatively assert claims against a transferee. However, the amount that a transferee may be required to pay on account of such a claim (other than through setoff) is limited to the amount of payments the transferee has received from the obligor.

<sup>3</sup> Section 9-404(a), which is quoted in full and discussed in detail starting on page [8].

From a fair presentation point of view, we question whether FASB wants to treat a transferor as still owning a financial asset, and the transferee as a creditor of the transferor, when all the economics of the financial asset have been transferred, and the only remaining link to the transferor is the possibility of setoff if the transferor happens to become insolvent at a time when the transferor has liabilities to the obligor.

Some setoff rights simply cannot be eliminated. A GAAP rule of zero tolerance for setoff would literally result in a situation where substantial categories of financial assets could never be derecognized. We are not talking just about securitizations. Even in a portfolio sale, with transfer of servicing and no recourse or other continuing involvement by the seller, some potential setoff rights cannot be eliminated. For example, in a portfolio sale by a retailer that originates and holds consumer credit contracts that are subject to the FTC Rule, the buyer will acquire those contracts subject to all claims and defenses which the obligor could assert against the retailer. Given that some defenses in consumer transactions could not be eliminated even by notice or waiver, it is hard to see a principles-based rationale for requiring that similar defenses be eliminated in other circumstances, simply because it is legally possible.

*Practicalities.* Many potential setoff rights can be eliminated by notice to obligors. The question is whether GAAP should force buyers and sellers to provide these notices in circumstances where the commercial decision would otherwise be that notice was not worth the expense, or possibly even was undesirable (due to potential confusion or disruption of customer relationships). Similarly, outside of the consumer credit context, a buyer of financial assets can acquire those assets free of claims and defenses that the obligors may have against the seller if the obligors have waived those claims and defenses. However, a waiver of this type is unusual outside of commercial loan agreements. Should GAAP require that these waivers be obtained in order for a seller of the financial assets to achieve derecognition? We believe that the answer to both of these questions, relating to notification and waivers, is “no.” To require these steps would be to go beyond what the commercial and legal worlds think of as necessary for a sale.

Elsewhere in GAAP, the retention of a small amount of risk does not preclude sale treatment. For example, under SEC Staff Accounting Bulletin Topic 5E, the principal consideration in determining whether the legal transfer of ownership of an operation results in a sale is whether the significant risks and rewards of ownership are transferred to the buyer. The retention of a limited amount of risk or other continuing involvement with the assets transferred would not normally preclude sale treatment. A similar standard is applied to accounting for sales of real estate in Statement 66, Accounting for Sales of Real Estate, where as long as the seller has transferred the risks and rewards of ownership, and does not have a substantial continuing involvement with the property, sale treatment is permitted.

We recognize that Statement 140 applies a control standard, rather than risks and rewards. We do not believe, however, that the mere retention of setoff risk should be equated with retained control anymore than a small amount of retained risk or continuing involvement would preclude sale treatment under the other standards referenced above. Statement 140 itself permits many types of transfers with continuing involvement on the part of the transferor to be accounted for as sales, and most practitioners (as well as the relevant audit guidance) have assumed that paragraph 9(a) requires only reasonable, as

opposed to absolute, assurance. Therefore, we believe that the retention of the risk that a transferred asset may become subject to setoff rights on account of transferor liabilities if the transferor becomes insolvent is sufficiently remote that the mere existence of those rights should not preclude sale treatment.

*Theoretical vs. Actual.* One of the difficulties with the Board's initial approach is that often the theoretical risk of setoff on account of transferor liabilities cannot be ruled out, but the practical risk of setoff is zero. For instance, many (but not all) credit card banks engage solely in the credit card business and do not take retail customer deposits. The risk of a customer setoff subsequent to a transfer of credit receivables by such a bank is practically zero. However, theoretically the credit card bank could, subject to legal requirements, begin accepting deposits from cardholders subsequent to the transfer.

Other banks both originate credit card receivables and take retail customer deposits. However, many of these banks' cardholders do not maintain deposits with the banks. Even if a cardholder has deposits with the issuing bank, the cardholder has no incentive to setoff credit card receivables against the deposits as long as the deposits aggregate less than \$100,000 and therefore are fully covered by FDIC insurance. (This point applies generally for retail assets originated by banks.) Accordingly, even for banks that take retail deposits, the actual risk of deposit liabilities being setoff against credit card receivables is small.

The retail auto business also demonstrates the difference between the theoretical and the actual risk of setoff. Although the FTC Rule makes transferred auto loan receivables subject to theoretical obligor defense risk, in the vast majority of auto receivables originations this risk is of little actual impact. Most finance companies and banks in this business acquire receivables from automobile dealers that originate them with obligors. Under the FTC Rule, the finance companies and banks (and subsequent transferees from them) are subject to defenses that the obligor would have against the dealer. In actuality, what is this risk? The primary concern in the vast majority of auto purchases is the quality of the vehicle. This is handled by a warranty from the *auto manufacturer*, not from the dealer. Accordingly, defects in quality are dealt with by the obligor directly with the manufacturer through its authorized service centers, and set off as a result of quality issues will not occur.

The obligor on an auto receivable can theoretically have defenses against the originating dealer, but those theoretical defenses are unlikely to have any actual impact. For example, in theory the obligor might have a defense if the dealer was not properly licensed or did not comply with Truth in Lending Act requirements or mileage disclosure requirements. In the experience of market participants, these theoretical defenses have had no measurable impact on securitized pools of auto receivables.

As the foregoing examples indicate, if the Board adopts a standard of zero tolerance for setoff risk, the effect will be to prevent derecognition of financial assets in situations where all market participants acknowledge that the risk of setoff is not of any practical concern.

*Legal Isolation under Statement 140.* The Board seems to have initially taken the view that the current language of Statement 140 compels the conclusion that the potential for

setoff on account of transferor liabilities is inconsistent with derecognition. This is not the only reasonable reading of that language. In fact, we believe that a substantial portion of the readers of Statement 140 who were aware of the law of setoff have interpreted the isolation from creditors language as simply not applying to setoff.

In particular, we believe these readers reasonably thought that paragraph 9(a) of Statement 140 was meant to test whether, upon the insolvency of the transferor, *general creditors* of the transferor would have access to the transferred assets to satisfy their claims against the transferor. To put it another way, these readers thought that paragraph 9(a) established a requirement consistent with the general legal view of true sale. Setoff is not available to the general creditors but only to a single particular creditor – the obligor (and only if the transferor happens to have a matured liability to the obligor).<sup>4</sup> Consequently, we think that the Board could resolve this situation by an interpretation that would not require any amendment to Statement 140. However, if the Board feels that an amendment is necessary in order to permit derecognition where setoff rights on account of transferor liabilities may continue, then that amendment should be made.

*Participations.* Much of the Board's deliberations on setoff have focused particularly on the interplay of bank loan participations and potential setoff on account of deposits at the bank that grants the participation. Although participations and other undivided interests are sometimes used in securitizations, we will not address participations in this letter. We understand that the Loan Syndications and Trading Association will address those issues in detail. We support the positions advocated by the Loan Syndications and Trading Association and strongly believe that properly-drafted participation agreements should achieve derecognition. However, we are seeking to reduce duplication in the submissions to FASB by focusing this letter on assignments of financial assets by means other than participations.

#### *Responses to Staff Questions*

The staff's questions involve some very technical legal points. We think it will be helpful if we clarify some important distinctions and legal background points before answering those questions.

*Negotiable vs. Non-Negotiable Assets.* The law has long recognized that it is important to the smooth flow of commerce for some categories of financial assets to be transferable in the ordinary course, free and clear of most claims and defenses arising from actions of the transferor. The most extreme example of this is cash: if party A in good faith and without any wrongdoing by party A accepts a cash payment from party B on a bona fide debt owed by party B to party A, then party A generally does not have to worry about claims relating to party B's actions. Even with cash there are exceptions to this statement, but by and large sellers do not have to worry about how buyers came by the money that passes between them.

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<sup>4</sup> The Board might be concerned that this interpretation would create a broad exception, encompassing many other types of claims not yet considered by the Board. We do not believe that is the case. Setoff and the similar defense of recoupment, which is discussed below, are unique in giving a single creditor a claim against a particular asset.

Non-cash financial assets fall on a continuum as to how much they are like cash in this respect. The two categories that are the most like cash are negotiable instruments (for instance, bank checks and some promissory notes<sup>5</sup>) and securities. As to negotiable instruments, the law affords substantial protections to “holders in due course” – generally meaning someone who has acquired the instrument in the ordinary manner, without some obvious bad act. Most purchasers of securities also benefit from protections comparable to those enjoyed by a holder in due course of a negotiable instrument.

A commercial obligor on a negotiable instrument can raise very few defenses against a holder in due course based upon the conduct of a transferor. However, even a holder in due course is subject to the so-called “real defenses” – *i.e.*, infancy or incapacity of the obligor, illegality, duress and certain types of fraud. Also, any negotiable instrument that is a consumer credit contract must contain the legend referred to on page 2 above, which makes any holder of the contract subject to any defenses that the obligor may have against the seller of the underlying consumer goods. The FTC Rule is referred to as an “anti-holder-in-due-course rule” because the presence of the required legend prevents anyone who holds an instrument that contains the legend from becoming a holder in due course.<sup>6</sup> Similar anti-holder-in-due-course protections apply to some predatory lending claims.<sup>7</sup>

For other financial assets (which we sometimes refer to below as “non-negotiable assets”), the general rule is that a transferee cannot be in any better position than its transferor. Nevertheless, these types of financial assets are commonly bought and sold, including as part of sales of businesses, as separate portfolio sales and in securitizations. The law has moved towards providing some greater protections for buyers of these assets (particularly if the obligor has been notified of the sale) and facilitating their sale, but the protections are far less than what is provided for holders in due course of negotiable instruments and similarly protected purchasers of securities.

To apply these categories to commonly securitized assets: some mortgage and other loans are represented by negotiable instruments, and some of the assets in collateralized debt obligation transactions may be securities. Special purpose entities that acquire these assets for purposes of securitizations should often enjoy holder in due course or similar status. Otherwise, most assets that are securitized are non-negotiable. Some people argue that this is one of the driving forces behind the growth of securitization: increasing the

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<sup>5</sup> There are several formal requirements in order for an instrument to be “negotiable,” which are set out in Section 3-104 of the UCC. Most importantly, the instrument must contain (and must largely be limited to) an unconditional promise or order to pay a fixed amount of money, with or without interest or other charges described in the instrument, with payment to be made (a) either to the bearer of the instrument or to the order of a named payee (with technical exceptions applicable to checks) and (b) on demand or at a definite time.

<sup>6</sup> See UCC Section 3-106(d).

<sup>7</sup> 12 CFR 226.34(a)(2) requires that any purchaser or assignee of a closed end mortgage with interest rates or fees in excess of specified regulatory trigger levels must be furnished the following notice: “Notice: This is a mortgage subject to special rules under the federal Truth in Lending Act. Purchasers or assignees of this mortgage could be liable for all claims and defenses with respect to the mortgage that the borrower could assert against the creditor.” Some state predatory lending laws provide for similar assignee liability.

liquidity of non-negotiable assets.<sup>8</sup> We do not think it would be fruitful to try to resolve this issue by forcing more transactions into the negotiable asset mode, as that does not fit the underlying commercial arrangements. Non-negotiable assets will continue to be created in abundance. To fairly represent commercial reality GAAP must provide reasonable standards for the originators and subsequent owners of these assets to derecognize them.

*Setoff Rights of Different Parties.* The impact of a transfer of a non-negotiable asset on setoff rights varies substantially between the transferor and the obligor whose payment obligation is assigned. The law provides substantial protections to obligors on non-negotiable assets, to avoid having a transaction to which the obligor is not a party (the assignment of its payment obligation) cause a loss of important rights. In contrast, transferors are party to their assignment transactions. They do not need these protections, and they do not receive them. As discussed in more detail in our response to Question 1, a receiver for a transferor generally has no more setoff rights than the transferor had.

*Recoupment vs. Setoff.* These are two distinct defenses, but they are so similar that people often use the term “setoff” to cover both. In fact, it is not always obvious which term should be applied to a particular situation. “Recoupment” is a defense arising from the transaction that gave rise to the obligor’s payment obligation – 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. On non-negotiable assets, recoupment defenses cannot be eliminated, except by a waiver from the obligor. A waiver of this sort would often be inconsistent with ordinary commercial dealings, and in the context of consumer credit contracts it would often violate the FTC Rule.

“Setoff” is an obligor’s defense to its payment obligation on account of a claim it has against its creditor, where the obligor’s claim does not arise from the transaction that gave rise to the obligor’s payment obligation. The main example that FASB has discussed is the right of a borrower from a bank to setoff the amount of a deposit that it maintains at the bank against its loan obligation. Outside of the banking context, setoff rights are less common, but they can exist. An example would be where a company’s customer, who buys on short-term or other credit, is also independently a supplier to the company, also selling on short-term or other credit. At any given point in time each of the two companies may be indebted to the other. In almost all circumstances, there is at least a theoretical possibility that set off rights could arise between an obligor and its original creditor (assuming they have not been waived), for instance because the original creditor commits some mass tort that injures the obligor.

If FASB determines that some category of setoff rights is inconsistent with derecognition, we encourage FASB to describe that category clearly and not rely on legal terms of art,

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<sup>8</sup> For instance, in its release early this month relating to the treatment of asset-backed securities under the Federal securities laws, the Securities and Exchange Commission states: “Asset-backed securitization is a financing technique in which financial assets, in many cases themselves less liquid, are pooled and converted into instruments that may be offered and sold more freely in the capital markets.” Release Nos. 33-8419; 34-49644, p. 7 (available at <http://www.sec.gov/rules/proposed.shtml>).

given the great similarity between recoupment and setoff and the risk of confusion between the two.

We will now answer the questions for respondents.

1. *Is the information about setoff rights in the staff 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?*

As a general matter, yes the information is accurate. For completeness, we note a few related points or details that the staff paper did not discuss:

- A. Besides the common law right of setoff discussed in the staff paper, there are also statutory rights of setoff in New York<sup>9</sup> and may also be in other states. We have not conducted a survey, but believe that those statutes tend to codify the common law principles, as opposed to creating substantially different rights. Also, we note that the laws of non-U.S. jurisdictions might sometimes be applicable (*e.g.*, in the case of a non-U.S. obligor), and we understand that some such laws may not permit waiver of setoff or recoupment defenses.
- B. Contracts often address setoff, in one of three ways:
  - (i) One or more parties may waive the right of setoff. For instance, commercial borrowers from banks often waive their rights to setoff deposits and other bank liabilities against amounts the borrowers owe to the banks. Waivers of setoff are less common in other commercial contracts.
  - (ii) The contract may simply state that one or more of the parties has setoff rights, which would often exist without this statement.
  - (iii) The contract may seek to extend one or more parties' setoff rights. For instance, commercial loan agreements often state that a bank may setoff amounts that an affiliate of the bank owes to a borrower against the borrower's loan. There is little case law relating to these extended rights, and lawyers often voice uncertainty about their enforceability, due to a lack of mutuality. "Mutuality" is an element of the law of setoff that generally<sup>10</sup> makes setoff apply only where the party seeking to exercise

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<sup>9</sup> New York Debtor and Creditor Law Section 151.

<sup>10</sup> The exceptions to this general rule are Section 9-404(a) of the UCC and the various consumer protection laws discussed above, each of which essentially preserve an obligor's setoff rights notwithstanding a transfer that would otherwise destroy mutuality or give the assignee holder in due course protections.

setoff is both a creditor and a debtor of the same counterparty (acting in the same capacity<sup>11</sup>).

- C. Different categories of financial assets vary in the extent to which a transferee is subject to setoff risk arising from the transferor's actions. A holder in due course of a negotiable instrument or security takes that instrument or security largely free of these types of risks. Transferees of negotiable instruments who are not holders in due course (including because of anti-holder-in-due-course consumer protections discussed above) and transferees of non-negotiable assets are subject to these risks to a much greater extent. However, it would not be practical to force all payment obligations to be negotiable, nor is it appropriate in our view for GAAP to say that non-negotiable assets cannot be sold.
- D. The impact of transfer on setoff rights differs as between the transferring creditor, on one hand, and the obligor, on the other.
- (i) A true sale of whole financial assets should generally eliminate the transferor's setoff rights. Please note that this result has nothing to do with whether or not the buyer is a qualifying special purpose entity.
  - (ii) A receiver or similar official for a transferor generally steps into the transferor's shoes with respect to setoff rights. Generally, if a true sale of whole receivables has occurred prior to receivership, the receiver will have no setoff rights with respect to the assets that were sold. The FDIC, as receiver or conservator, has a specific statutory setoff right. However, that right only applies to assets of the institution in receivership, so it should not have any effect on assets that were the subject of a true sale prior to receivership.

There is no similar statutory setoff right for bankruptcy trustees. We also do not believe that the special insolvency laws applicable to broker-dealers<sup>12</sup> or New York branches of foreign banks<sup>13</sup> create any special setoff issues in the context of whole financial assets transferred by such an institution in a true sale prior to insolvency. Insolvencies of insurance companies are governed by state law, depending upon where the company is organized, and we have not conducted a survey of those laws.

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<sup>11</sup> To illustrate the "in the same capacity" requirement: a borrower cannot set off a loan obligation that it owes to a bank where the bank is principal against a debt owed to the borrower by a trust for which the bank is trustee.

<sup>12</sup> The Securities Investor Protection Act. Unlike banks, broker-dealers may be debtors in a proceeding under the Bankruptcy Code. The Securities Investor Protection Act does not create an entire separate insolvency regime. It merely makes some special provisions apply in a bankruptcy proceeding relating to a broker-dealer.

<sup>13</sup> The New York Banking Law.

Experienced practitioners have indicated that they believe that common law setoff principles generally apply in that context.

- (iii) For non-negotiable assets, much of the law governing the impact of a transfer on the setoff rights of obligors (which are referred to as “account debtors” in the UCC) is set out in Sections 9-404(a) or 9-408 of the UCC. Section 9-404(a), which applies to “accounts”<sup>14</sup> (other than health care insurance receivables), “chattel paper”<sup>15</sup> and (subject to some modifications by Section 9-408) general intangibles,<sup>16</sup> is so important that it is worth quoting its text in full:

“Unless an account debtor has made an enforceable agreement not to assert defenses or claims, and subject to subsections (b) through (e),<sup>17</sup> the rights of an assignee are subject to:

(1) all terms of the agreement between the account debtor and assignor 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 account debtor against the assignor which accrues before the account debtor receives a notification of the assignment authenticated by the assignor or the assignee.”

There are several points worth noting on this language:

- The exception in the lead-in language where “an account debtor has made an enforceable agreement not to assert defenses or claims” is a statutory recognition that setoff rights can be waived by contract (except as otherwise provided in consumer protection laws).

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<sup>14</sup> “Accounts” is a UCC category that covers a broad range of financial assets, including most rights to payment for property that has been sold and credit card receivables.

<sup>15</sup> “Chattel paper” includes most retail installment paper and leases.

<sup>16</sup> “General intangibles” is a UCC catch-all for intangible assets other than accounts, chattel paper, instruments (a term that includes negotiable instruments and some other similar assets), securities and a few other specific categories. Obligations to make payments on loans are general intangibles, to the extent that the loan is not evidenced by an instrument and is not an account. Section 9-408 effectively cancels the effect of notice to cut off the defenses described in paragraph (2) of Section 9-404(a) with respect to general intangibles, unless the obligor has agreed that the general intangible may be assigned.

<sup>17</sup> Subsections (b) through (e) contain some special exceptions that either are not relevant to the current discussion or are referred to generally below.

- Paragraph (1) describes recoupment rights, which cannot be eliminated except by a specific agreement from the account debtor, subject to consumer protection laws.
- Paragraph (2) describes setoff rights, which can be eliminated by notifying the account debtor of the sale, insofar as they accrue after the notice is received. Setoff rights relating to claims that exist prior to or at the time that notification is received cannot be eliminated, except by a specific waiver from the account debtor, if a waiver is permitted by consumer protection laws.
- Although notice to, or waivers from, obligors can often protect buyers from some defenses arising from the conduct of their sellers, we do not believe that FASB should require obligor notice or waivers as a condition of derecognition. Complying with any such requirement would often involve substantial direct and indirect expenses, and would often be inconsistent with the commercial preferences of the buyer and seller and/or consumer protection laws.

- (iv) In many consumer credit transactions, the ability to eliminate defenses available to an account debtor against its original creditor is further limited. Without claiming to be exhaustive, these include the FTC Rule and the predatory lending rules referenced above.

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

Lawyers who render true sale opinions are very much aware of the law of setoff and related matters discussed above. The bar generally does not consider such rights to be relevant to the question of whether or not a true sale has occurred. There are two main reasons for this:

- The law very clearly treats true sale and survival of obligor defenses as two distinct issues and explicitly provides that some obligor setoff defenses continue in the case of a true sale. “True buyers” and pledgees are treated in the same way for purposes of an obligor’s setoff and recoupment rights. For instance, UCC Section 9-404(a) discussed above applies equally to buyers in true sales and secured parties in secured lending arrangements. Consequently, lawyers, along with 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. These risks affect the quality or nature of the transferred asset, rather than the question of whether the asset has been sold.
- As discussed on page 2 above, the law looks at true sale and many other property issues using a bundle of sticks analysis. In the context of that analysis, setoff rights are not viewed as a very important factor.

While we are on the topic of legal opinions, we would like to address another point. To the extent that the Board adopts an interpretation of legal isolation that goes beyond true sale, it is likely to be impracticable to obtain legal opinions covering the incremental requirements. Among other reasons:

- For most assets, not all recoupment and setoff defenses can be eliminated in the absence of an agreement between the obligor, the transferor and the transferee – and for some consumer assets any such agreement violates consumer protection laws. Accordingly, attorneys asked to address recoupment and setoff defenses will often be unable to opine that all recoupment and setoff defenses have been eliminated.
  - We hope that the resolution of this issue will take into account a number of practical issues. For instance, if assets are originated by a non-bank, or a bank that has little or no deposits, then post-transfer setoff rights are much less likely to arise, but that does not mean that they legally could not arise. A bank could increase its deposits, or any transferor could incur other liabilities to obligors on transferred assets, for instance because of some environmental claim or mass tort. It seems very hard to justify a requirement that obligors be notified of a transfer in order to eliminate future setoff rights where there is no reasonable expectation that any liabilities giving rise to such rights will arise. However, lawyers will not be able to say that such liabilities could never arise.
3. *What additional information about setoff rights should the Board consider? For example,*
- a. *Does a setoff right exist between the original debtor and the transferee?*
  - b. *Do setoff rights exist if an affiliate of the transferor has a liability to the obligor?*

The answer to Question (a) is complicated, because it depends upon the nature of the assets transferred, whether any defenses have been waived and possibly other factors. We are reluctant to answer at length because we are not certain what the Board's real concerns are. Generally, many of the points made in our response to Question 4 below would be relevant to a complete answer to Question (a).

The answer to Question (b) is no, due to lack of mutuality. Theoretically, a different answer to Question (b) would apply if a transferor and its affiliate were substantively consolidated in insolvency. This is not a practical issue in most circumstances, and in any event a true sale to a bankruptcy remote entity or a non-affiliate would eliminate any setoff rights that the affiliate might claim.

As indicated in our response to Question 1 above, some contracts extend setoff rights to cover this situation, for the benefit of a lender and its affiliates. Because these contracts are inconsistent with the common law mutuality requirement, many lawyers question whether they are enforceable.

Our other responses provide additional information about setoff defenses that we believe the Board should consider. We have nothing to add here that is not captured in our other responses.

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?*

Our discussion above already includes the answer to this question. To briefly reiterate:

- The transferor's setoff defenses are generally eliminated by a true sale of the asset, because the sale eliminates mutuality.
  - Subject to the exception stated below, a receiver or similar official in a transferor's insolvency will have no greater setoff rights than would the transferor. So a true sale that eliminates the transferor's setoff rights will also eliminate a receiver's setoff rights. The exception is that some waivers of setoff rights by a bank may not be effective against the FDIC as receiver. Note that this exception does not give the FDIC a setoff right where there has been a true sale of whole financial assets.
  - As to obligors on non-negotiable assets, a transfer by itself does not cut off any defenses. Notice to the obligor will often cut off setoff defenses that accrue after the date that notice is received, except for defenses that are preserved under consumer protection laws and defenses relating to health care-insurance receivables and some general intangibles. Also, obligors can contractually waive setoff defenses, except as limited by consumer protection laws. On negotiable assets, a proper transfer cuts off all obligor defenses, except the "real defenses" – infancy, incapacity, illegality, duress and certain types of fraud – and consumer claims preserved by various anti-holder-in-due-course rules.
  - Transferors of financial assets generally represent to their transferees that the obligors have no actual (as opposed to potential) defenses to payment of the transferred assets. Absent extraordinary concern about the likely scope of defenses or the transferor's creditworthiness, the market views those representations as adequately mitigating these risks.
  - Typically the terms of credit agreements governing commercial and corporate borrowings provide for obligor waiver of setoff and, in many cases, recoupment defenses. However, other financial arrangements between the obligors and transferors or non-bankruptcy remote affiliates of transferors (for example, swap master agreements) may provide for setoff defenses between the parties.
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.*

We strongly discourage the Board from adopting this new definition, as it brings into play a host of new subjective determinations and would certainly generate many difficult new issues for reporting companies, practitioners and the Board. Unless the Board adopted an extensive set of exceptions, materiality standards and interpretations, virtually no sale of a financial (or any other) asset could meet this test. For instance, in any transfer with servicing retained, the financial condition of the servicer can affect the quality of its servicing and hence the value of the serviced assets. Also, as discussed above, for many financial assets there are some risks relating to the transferor that cannot practically – or sometimes legally – be eliminated. As remote as these contingencies are, it is hard to say that the financial condition of the transferor whose representations cover these risks has no effect at all on the value of the assets.

Responding to the actual question, we note first that we do not believe it is correct to say that attorneys do not consider setoff in rendering true sale opinions. Opinion givers are aware of the risk of setoff, and consider it, but that risk does not materially affect the true sale analysis. We offer the following list of other factors that may be affected by a change in creditworthiness of the transferor and which do not generally preclude the delivery of a true sale opinion:

- *Recoupment rights.* As mentioned above, recoupment is legally distinct from setoff, though the two defenses are similar in their operation and effect. The analysis of potential recoupment rights in the true sale context is also similar to the analysis of potential setoff rights, as described in our answer to Question 2 above.
- *The “real” defenses, fraud, etc.* In giving true sale opinions, lawyers generally assume that the transferred receivables are valid obligations, created in accordance with legal requirements. These are usually intensely factual questions, and it is generally not the role of a transactional lawyer to audit or investigate the underlying facts.
- *Warranty buybacks and indemnities.* Sellers of assets (financial or otherwise) customarily make representations as to their own status, the characteristics of the assets they are selling and their conduct in connection with the assets. Buyers usually have remedies, such as the right to put back assets and/or indemnities from their sellers, in the event those representations are false in a manner that materially impairs the quality of the purchased assets or otherwise exposes the buyer to liability or loss. As long as these representations and remedies do not excessively cover the future credit risk on transferred receivables, they are not generally considered to be inconsistent with a true sale.
- *Fraudulent conveyance and voidable preference.* These are two remedies available to bankruptcy trustees and many other insolvency receivers to pull back property that was transferred by an entity when it was insolvent or close to insolvency and when the transfer is made either for inadequate consideration

(fraudulent conveyance) or in a manner that would advantage one creditor over others (voidable preference). Givers of true sale opinions generally either expressly assume that the subject transfers are neither fraudulent conveyances nor voidable preferences, or else assume that the necessary elements for a fraudulent conveyance or voidable preference are not present. In particular, true sale opinions generally assume that the seller is solvent at the time of sale (and after giving effect to the sale) and that the compensation received by the seller is adequate.<sup>18</sup> These are factual matters that are not the special competence of legal opinion givers. A legal opinion on these points is generally meaningless, because the only way that a lawyer can give the opinion is by assuming that the necessary factual elements are not present.

- *Servicing risks.* An owner of financial assets who uses an independent entity as servicer inevitably bears some risks relating to that servicer. This is true whether the servicer is a former owner of the financial assets or not. True sale opinions usually disclose and discuss some of these risks, but the risks are generally not considered to be inconsistent with a true sale.

We do not believe that any of these other risks rise to the level of setoff risks, and we do not believe that the presence of setoff risks or any of these other risks should preclude derecognition.

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The ASF appreciates the opportunity to provide the foregoing comments. We hope to participate, through attorney members, in the roundtable discussions on these issues. Should you have any questions or desire any clarification concerning the matters addressed in this letter, please do not hesitate to contact me via the ASF, at 646.637.9200.

Sincerely,

/s/ Vernon H.C. Wright

Vernon H.C. Wright  
Chairman  
American Securitization Forum

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<sup>18</sup> Paragraph .10 of AU 9336 expressly acknowledges that opinion givers assume fair consideration.