

RECENT DEVELOPMENTS IN AND LEGAL IMPLICATIONS OF ACCOUNTING FOR SECURITIZATIONS

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INTRODUCTION

*Nothing like a few superstars to turn the spotlight on a little-noticed trend.*¹

When British rock star David Bowie raised fifty-five million dollars in one day in 1997 by selling bonds backed by his future record royalties, what was once a topic discussed only in highly specialized circles of accountants, lawyers, and finance and corporate professionals became a topic that any newspaper reader could learn about.² Following Bowie's lead, music industry icons such as Luciano Pavarotti, the Rolling Stones, and Michael Jackson have all considered similar deals to raise cash immediately rather than wait for royalties to be paid out in the future.³ Since the 1980s, these transactions, known as securitizations, have rapidly developed into a nearly half-trillion dollar per year industry.⁴ Most securitizations involve home mortgage, car, or credit card loans; however, a wide variety of transactions including student loans, lottery winnings, court settlement proceeds, and unsold airline tickets have been securitized under the recent trend.⁵ Recent regulatory actions in the accounting profession have required significant changes in the way some of these transactions are structured and have cast a great

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1. Kathy Bergen, *A Star Turn Banking on the Future*, CHI. TRIB., Dec. 5, 1997, Business, at 1.

2. *See id.*; *Smart Bonds*, S.F. EXAMINER, Mar. 25, 1997, Business, at D-1.

3. *See* Bergen, *supra* note 1, at 1; Keith J. Kelly, *Bonds Could Raise \$100M to Backo Jacko*, N.Y. POST, Nov. 16, 1998, Business, at 34.

4. *See* Robert Dean Ellis, *Securitization Vehicles, Fiduciary Duties, and Bondholders' Rights*, 24 J. CORP. L. 295, 296 (1999).

5. *See* Ronald S. Borod, *Origin and Evolution of Securitized Structures*, in SECURITIZATION: ASSET-BACKED AND MORTGAGE-BACKED SECURITIES 1-1, 1-39 to 1-48 (Ronald S. Borod ed., 1996); Aaron Elstein, *If It Moves, David Pullman Might Securitize It*, AM. BANKER, Feb. 28, 1997, at 1; Bergen, *supra* note 1, at 1.

deal of uncertainty on whether they will remain advantageous for parties seeking to raise capital.

This Note discusses how these regulatory accounting changes affect the legal structure of securitization of financial asset transactions. Part I introduces and explains securitization transactions. Part II discusses the accounting issues surrounding securitization transactions. Part II(A) describes the history of applicable accounting standards relevant to these types of transactions. Part II(B) explains the pre- and post-1996 accounting methods, and analyzes proposed changes, published in mid-1999, to the accounting rules. Part II(C) discusses a specific term in securitization transactions known as a removal of account provision, analyzing the impact of such provisions on securitization transactions. Part III analyzes the legal requirements for securitizations that flow from the accounting rules. Part III(A) examines the imprecise law governing a “true sale” as applied to general corporate entities. The true sale test determines whether a securitization will be considered a sale for accounting purposes. Part III(B) addresses the true sales as they relate to regulated financial institutions. Finally, Part III(C) examines the attorney’s role, as well as the attorney’s relationship with the accountants, in securitization transactions.

I

THE NATURE OF SECURITIZATIONS

Securitizations of financial assets can broadly be defined as transactions in which an entity pools together loans, accounts, or other financial rights to receive a payment in the future, and then sells the rights to those receivables to investors⁶ in the form of securities.⁷ For example, a bank might pool credit card accounts or auto loan receivables and transfer those assets to what is commonly known as a “special purpose entity” (“SPE”).⁸ In a typical securities transaction, the accounts are then evaluated by underwriters for credit risk and a credit agency assigns a credit risk rating to the

6. Presently the overwhelming majority of investors are institutional investors, such as pension funds and mutual funds.

7. See Borod, *supra* note 5, at 1-3.

8. An SPE may generally be thought of as a typical subsidiary, except that the subsidiary is established for a special (and restricted) purpose—namely, holding financial assets and issuing securities backed by those financial assets. As will be discussed below, the SPE vehicle is needed to separate the remaining assets of the transferor from the assets relating to the securities.

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securities.⁹ Finally, the SPE issues debt securities or other interests to investors. The cash received by the SPE for the interests is used to pay the transferor for the accounts purchased. Over time, the SPE collects the cash generated by the accounts receivable or loans and distributes it to the security holders. While securitizations can be backed by non-financial assets, the rule-making bodies discussed below have limited the scope of their pronouncements to financial assets only.¹⁰

SPEs typically are created specifically for taking part in the securitization transaction. Their form is most often that of a trust or a corporation, meaning that either trust interests or typical corporate securities are issued by the entity.¹¹ Under current Statement of Financial Accounting Standard 125 ("FAS 125"),¹² to be a "qualifying" SPE, an SPE must be a trust, corporation, or other legal vehicle whose activities are permanently limited to: (1) holding title to transferred assets; (2) issuing beneficial interests; (3) collecting and reinvesting cash proceeds from assets and servicing assets; and (4) distributing cash proceeds. Additionally, the SPE must have standing at law distinct from the transferor.¹³ These requirements have been substantially amended, however, by the exposure draft of the amended FAS 125, issued in June of 1999.¹⁴ Under the proposed revision, a qualifying SPE must be a trust or other legal vehicle that has (1) standing at law distinct from the transferor; (2) significant limits placed on its activities and its permitted activities specified in its formative documents; (3) holdings that are restricted to financial assets transferred to it and other assorted types of assets; and (4) restrictions on when it can distribute or sell trans-

9. For a detailed analysis of how an organization assigns a credit rating to securitization transactions, see Standard & Poor's Ratings Services, *Legal Issues in Rating Structured Finance Transactions 1* (1998), available at *Standard & Poor's Ratings Services: Legal Issues in Rating Structured Finance Transactions* (visited Mar. 28, 2000) <<http://www.standardandpoors.com/ratings/criteria/structuredfinance>>, *legal.htm* link.

10. See ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENTS OF LIABILITIES, Statement of Financial Accounting Standards No. 125 ¶ 1 (Financial Accounting Standards Bd. 1996) [hereinafter FASB STATEMENT NO. 125].

11. See G. Larry Engel & Andrew B. Koslow, *Securitization Advice For Asset-Based Lenders*, in *ASSET BASED FINANCING, INCLUDING SECURITIZATION AND ACQUISITION FINANCING* 473, 495 (James J. Cunningham & G. Larry Engel eds., 1995).

12. Financial Accounting Standards are published by the Financial Accounting Standards Board ("FASB") and for the most part constitute generally accepted accounting principles ("GAAP").

13. See FASB STATEMENT NO. 125, *supra* note 10, ¶ 26.

14. See discussion *infra* Part II(A).

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ferred assets to parties other than the transferor or its affiliates.¹⁵ These changes reflect the Board's revised understanding of most SPE activities, and therefore expand the permissible activities to align them with current practices. The new language is more detailed but less restrictive, and should alleviate constituents' fears that certain practices preclude an entity from being considered a qualifying SPE.¹⁶

Securitization transactions have proven to be beneficial for transferors for many reasons. To begin with, they allow transferors to obtain funds at favorable interest rates.¹⁷ For example, the financing arm of a new automobile manufacturer may have a set of automobile loan receivables on its books but very little cash with which to grow; those receivables may comprise the majority of the financing company's assets. The financing company might initially consider offering ordinary bonds in order to raise money. The credit rating of these bonds, however, would reflect the fact that the receivables, the primary assets of the company, would be governed by bankruptcy laws upon the company's filing for bankruptcy protection. Any creditors with higher bankruptcy priority than the bondholders would satisfy their claims with these assets, which would then be unavailable to the bondholders. Accordingly bondholders would, and do in practice, command a higher interest rate on the bonds to compensate them for this risk of bankruptcy.

In the alternative, the financing company might embark on a securitization transaction using its pool of receivables. To begin the transaction, the company transfers the receivables to an SPE which generates cash by issuing debt securities backed by the receivables. If the transfer to the SPE meets the criteria of a true sale, the assets will be beyond the reach of the bankruptcy creditors of the financing company, which in turn will permit the bonds to have a higher credit rating; the bonds will effectively be insulated from the bankruptcy of the transferor. In evaluating risk, the buyers of the securities will then look to the cash flow from the receivables themselves, instead of to the credit rating of the transferor. This higher

15. See PROPOSED STATEMENT OF FINANCIAL ACCOUNTING STANDARDS, Accounting for Transfers of Financial Assets, an Amendment of FASB Statement No. 125, ¶ 5j (Financial Accounting Standards Bd. 1999) (amending FASB STATEMENT NO. 125, *supra* note 10, ¶ 26) [hereinafter PROPOSED AMENDMENT OF FASB STATEMENT NO. 125].

16. See *id.* at *Issue 1*. The accounting impact of the SPE rules is discussed *infra* at Part II(B).

17. See Borod, *supra* note 5, at 1-7; Anand K. Bhattacharya & Frank J. Fabozzi, *The Expanding Frontiers of Asset Securitization in ASSET-BACKED SECURITIES* 1, 7 (Anand K. Bhattacharya & Frank J. Fabozzi eds., 1996).

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credit rating allows for a lower interest rate, and allows the SPE to use the same set of assets to raise more capital for the financing company than the financing company would have been able to raise on its own.¹⁸

The second and equally important reason to engage in securitization transactions is for favorable accounting treatment, known as off-balance-sheet financing.¹⁹ These rules allow the transferor to increase the liquidity²⁰ of the balance sheet and lower its debt-to-equity ratio because the transferor immediately recognizes income and possibly gain from the sale of the accounts but recognizes no corresponding liability.²¹ This advantage, however, is contingent upon the transferor relinquishing control of the assets and the transaction being labeled a “true sale,” as discussed below in Part III(A).²²

Over the past 15 years, demand for securitization securities by institutional investors has increased greatly. Institutional investors tend to be attracted to the high credit quality and rating,²³ high yield,²⁴ and relatively short maturity of these securities.²⁵ Accounting for the investor is done via FAS 115, and the securities, like all other investments held by an investor, are categorized as held-to-maturity, trading, and available for sale.²⁶

While the number of securitization transactions has rapidly increased, so has the number of critics of these transactions. Critics often point out that securitization pools²⁷ tend to include more se-

18. See Michael J. Cohn, Note, *Asset Securitization: How Remote is Bankruptcy Re-
mote?* 26 HOFSTRA L. REV. 929, 934 (1998); STANDARD & POOR'S RATINGS SERVICES,
supra note 9, at 1; STEVEN L. SCHWARCZ, STRUCTURED FINANCE: A GUIDE TO THE
PRINCIPLES OF ASSET SECURITIZATION 1-2 (2d ed. 1993).

19. See PETER H. WEIL, ASSET-BASED LENDING: A PRACTICAL GUIDE TO SECURED
FINANCING 2-14 to 2-15 (3d ed. 1998); Borod, *supra* note 5, at 1-5.

20. Liquid assets are generally those in cash or which readily can be converted
into cash. Financial receivables are illiquid assets as they mature well into the
future.

21. See WEIL, *supra* note 19, at 2-14 to 2-15.

22. See Gregory D. Kane, *Accounting for Transfers of Financial Assets under SFAS
No. 125: Risks and Rewards Are Out, and Control and Financial Components Are In*, CPA
J., Mar. 1997, at 14-15.

23. See THE ASSET SECURITIZATION HANDBOOK 30 (Phillip L. Zweig ed., 1989).

24. See *id.* at 32; Bhattacharya & Fabozzi, *supra* note 17, at 11; Borod, *supra*
note 5, at 1-10 to 1-11.

25. See Bhattacharya & Fabozzi, *supra* note 17, at 10.

26. See Len Blum & Evan Mitnick, *Introduction to ABS Accounting*, in ASSET-
BACKED SECURITIES 369, 380 (Anand K. Bhattacharya & Frank J. Fabozzi eds.,
1996).

27. In securitization parlance, a securitization pool is a pool of financial assets
that is sold to a SPE. See Borod, *supra* note 5, at 1-3, 1-5.

cure, lower-risk loans, leaving higher-risk loans in the possession of the transferor.²⁸ While this practice reduces the transferor's due diligence expenses and increases the credit rating of the pool, investors in the transferor argue that they are left with an inferior asset base, increasing their risk of non-payment in the event of bankruptcy.

A second major criticism of securitization transactions is that they are merely "window dressing," that is, transactions enabling a financially distressed company to create off-balance-sheet financing and, in the process, to present a false picture of the company to the market.²⁹ The false picture occurs because after the transaction, the balance sheet appears stronger because cash has increased without a corresponding liability. Alternatively, if the securities issued by the SPE receive a high rating, it might signal improvement in the transferor's business when, in fact, the improvement has nothing to do with the stability of the transferor, and merely relates to its financial statement preparation. Regardless of the number of critics, however, securitization transactions have undoubtedly infiltrated the financial instrument market and, assuming that favorable accounting treatment continues, they will likely persist there.

II

ACCOUNTING FOR SECURITIZATIONS

A. *The History of Standards Applicable in Securitization Transactions*

Throughout the 1980s and early 1990s, securitization transactions were governed by FAS 77, "Reporting by Transferors for Transfers of Receivables with Recourse."³⁰ Because FAS 77 did not contemplate accounting for securitization transactions specifically, it left many questions unanswered.³¹ Over time, the appropriate rule-making bodies³² became increasingly concerned that accounting results were the driving force behind securitization transactions,

28. See Bhattacharya & Fabozzi, *supra* note 17, at 17.

29. See *id.* at 18.

30. REPORTING BY TRANSFERORS FOR TRANSFERS OF RECEIVABLES WITH RECOURSE, Statement of Financial Accounting Standards No. 77 (Financial Accounting Standards Bd. 1983).

31. See James Johnson, *Accounting Issues, in* SECURITIZATION OF FINANCIAL ASSETS 19-5 (Jason H.P. Kravitt, ed. 1997).

32. These bodies include the FASB, the Emerging Issues Task Force of the FASB (the "EITF"), the American Institute of Certified Public Accountants (the "AICPA"), and the Securities and Exchange Commission (the "SEC"). See Mark T. Shreckgast, *Accounting Considerations, in* SECURITIZATION: ASSET-BACKED AND MORTGAGE-BACKED SECURITIES 3-1, 3-2 (Ronald S. Borod ed., 1996).

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and that the economic substance of the transactions was only secondary.³³ Accordingly, the Financial Accounting Standards Board ("FASB") wrote a new statement dealing specifically with securitizations. In June of 1996, it issued FAS 125, which supersedes FAS 77 as the authoritative standard on accounting for securitizations.³⁴

Because the promulgation of FAS 125 was met with considerable implementation confusion, the FASB has more recently been considering amendments to and clarifications of FAS 125. Six months after FAS 125 was originally issued, the FASB undertook a reevaluation of certain isolated issues raised by it.³⁵ The scope of the issues needing clarification, however, grew so substantial that a full amended statement became necessary. In June of 1999, the FASB published an exposure draft proposing revisions to FAS 125. Constituents had until September 27, 1999, to submit comments on the exposure draft to the FASB;³⁶ the FASB will continue discussing the revision of FAS 125 by analyzing the comment letters during the fourth quarter of 1999.³⁷ The FASB anticipates issuing the final amended statement during the fourth quarter of 2000.³⁸

The FASB has also issued an updated implementation guide for FAS 125. In July of 1999, the FASB issued the final Special Report on Implementation of FAS 125;³⁹ the third edition includes clarification of the scope of FAS 125 and answers many specific questions relating to SPEs. Currently, the accounting and legal professions wait only for the final amended FAS 125.

B. Accounting Under Original and Revised FAS 125

The proper accounting for a securitization transaction depends upon whether the transfer from the transferor to the SPE is a

33. *See id.*

34. *See* FASB STATEMENT NO. 125, *supra* note 10.

35. *See* Halsey G. Bullen & Kristen C. Heller, *Accounting for Transfers of Financial Assets Amending FASB Statement 125*, VIEWPOINTS: STATUS REPORT FEATURE (Financial Accounting Standards Bd.).

36. *See* PROPOSED AMENDMENT OF FASB STATEMENT NO. 125, *supra* note 15, at cover.

37. Forty comment letters were received and will be used by FASB in deciding on the language of the final rule. A summary of the letters can be viewed at *Amendment of Statement 125—Summary* (visited Mar. 28, 2000) <<http://www.rutgers.edu/Accounting/raw/fasb/project/125summary.html>>.

38. *See id.*

39. *See* FASB, Special Report: A Guide to Implementation of Statement 125 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, Questions and Answers, Third Edition, (1999).

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“true sale.”⁴⁰ The drafters of FAS 125 considered making the key determinant of a “true sale” the transfer of risk of loss. Nonetheless, they chose to focus on control, making it the cornerstone of the new statement.⁴¹

The current FAS 125 states that “a transfer of financial assets in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange.”⁴² According to paragraph 9 of FAS 125, control has been surrendered only if the following three conditions have been met:

- a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership
- b. Either (1) each transferee obtains the right—free of conditions that constrain it from taking advantage of that right . . . to pledge or exchange the transferred assets or (2) the transferee is a qualifying special-purpose entity . . . and the holders of beneficial interests in that entity have the right—free of conditions that constrain them from taking advantage of that right . . . to pledge or exchange those interests.
- c. The transferor does not maintain effective control over the transferred assets through (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity . . . or (2) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable⁴³

Paragraph 9 is thus the key paragraph for all accounting and legal considerations concerning the proper treatment of securitized assets as controlled by the transferor or by the SPE.

If the transfer is considered a sale, then after it has occurred, the transferor may retain certain interests in the transferred assets, including servicing interests, beneficial interests, and retained undivided interests.⁴⁴ These retained interests must be carried on the

40. See Engel & Koslow, *supra* note 11, at 479.

41. See Johnson, *supra* note 31, at 19-7.

42. FASB STATEMENT NO. 125, *supra* note 10, ¶ 9.

43. *Id.*

44. See *id.* ¶ 10. Retained interests include all interests kept by the transferor in the transferred assets. An example would be the rights to income from servicing the assets. If the transferor retains the right and the corresponding income from servicing (collecting principal and interest, paying taxes, monitoring delinquencies, etc.) the assets, the transferor must carry that interest on its balance sheet.

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balance sheet, and the carried amounts must be allocated between the assets sold and the retained interests based on fair value at the date of transfer.⁴⁵ More specifically, when a securitization is treated as a sale, a snapshot of the balance sheet must be taken before and after the transaction.⁴⁶ To begin with, the transferor must identify all financial components arising out of the transaction.⁴⁷ Under FAS 125, each financial component must be evaluated separately; different accounting treatment may be applied to different components.⁴⁸ Cash and any other sale proceeds must then be added to the assets of the seller, and the sold accounts must be removed from the balance sheet.⁴⁹ The seller must then recognize a gain or loss if the value of the assets sold differs from the proceeds of the sale.⁵⁰

If the transaction does not meet the requirements of paragraph 9 and is not considered a true sale, it will be considered a secured financing arrangement and the receivables and associated debt will remain on the balance sheet of the transferor. The transaction will be governed by Article 9 of the Uniform Commercial Code ("UCC").⁵¹ An offsetting liability will correspond with the increase in assets from the sale proceeds.⁵² It is important that both the transferor and the SPE account for the same transaction using the same principles: true sale or secured financing.⁵³

The recently-published exposure draft proposes helpful changes to the description in paragraph 9 of whether a transferor has surrendered control over transferred assets. More importantly, however, the exposure draft leaves paragraph 9(a), requiring that the transferred assets be beyond the reach of creditors in bankruptcy, completely intact. The amended paragraphs 9(b) and (c)

45. *See id.*

46. *See* James Johnson, *Accounting Issues, in* 2 SECURITIZATION OF FINANCIAL ASSETS 19-1, 19-28 (Jason H.P. Kravitt ed., 2d ed. 1996).

47. This is known as the financial components approach. Complex financial instruments are broken into their underlying components and each party (the transferor and the SPE) recognizes the components it controls. Each component can only be controlled by one party at a time. *See* Tommy Moores & Anthony F. Cocco, *Audit Considerations Under SFAS 125*, OHIO CPA J., Jul.-Sept. 1997 at 21, 21.

48. *See id.*

49. *See* Johnson, *supra* note 46, at 19-5.

50. *See id.*

51. For a general discussion of both current and revised Article 9 as applied to securitization transactions, see Paul M. Shupack, *Making Revised Article 9 Safe for Securitizations: A Brief History*, 73 AM. BANKR. L.J. 167 (1999).

52. *See* Johnson, *supra* note 46, at 19-41.

53. *See* Michael H. Trager, *Is Securitization In Your Future? THE SECURED LENDER*, Jul./Aug. 1998 at 74.

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state that control has been transferred if all of the following conditions are met:

b. If the transferee is a qualifying special-purpose entity (SPE) . . . :

(1) The holders of beneficial interests in that entity have the right to pledge or exchange those interests and no condition both constrains them from taking advantage of that right and provides more than a trivial benefit to the transferor. . . .

(2) The transferor does not retain effective control over transferred assets through the ability to unilaterally cause the transferee to return specific assets, other than through a cleanup call. . . .

c. If the transferee is *not* a qualifying SPE:

(1) Each transferee obtains the right to pledge or exchange the transferred assets and no condition both constrains it from taking advantage of that right and provides more than a trivial benefit to the transferor. . . .

(2) The transferor does not maintain effective control over the transferred assets through an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity⁵⁴

This revised language was designed to address two issues: first, to what extent constraints on the SPE's ability to provide a security interest in or exchange the assets precluded sale accounting,⁵⁵ and second, whether the SPE must obtain *either* the right to pledge *or* the right to exchange transferred assets, or whether *both* rights must be obtained from the transferor in order to secure sale accounting treatment.⁵⁶ With respect to the first issue, the FASB concluded that more than a trivial benefit must be conferred upon the transferor by a constraint on the SPE's ability to provide a security interest in or exchange the assets in order to preclude sale accounting. As to the second issue, the FASB concluded that either a pledge or an exchange right will be sufficient for sale treatment. These changes to paragraph 9 also distinguish between the rules applying to qualifying SPEs and the rules applying to transfers to other entities. Accordingly, the more detailed yet less restrictive definition of

54. PROPOSED AMENDMENT OF FASB STATEMENT NO. 125, *supra* note 15, app. C ¶ 9 (formatting in original).

55. Precluding the SPE from pledging or exchanging the assets could provide substantial benefit to the transferor by allowing the transferor to retain a degree of control over the assets.

56. *See* PROPOSED AMENDMENT OF FASB STATEMENT NO. 125, *supra* note 15, at ¶ 18.

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a qualifying SPE⁵⁷ allows for more transactions to fall within the scope of paragraph 9(b) and also allows for greater certainty.

FAS 125 also governs the accounting for asset servicing; asset servicing refers to collecting interest and principal payments as well as instituting collection proceedings upon default of an account.⁵⁸ Under FAS 125, each time a transferor undertakes an obligation to service financial assets, it must recognize a servicing asset for the servicing contract. If there has been a true sale, the asset should be measured initially at fair value and should be amortized over the life of the asset.⁵⁹

C. Specific Accounting Rules for Removal of Accounts Provisions

In addition to considering general amendments to FAS 125, the FASB is also considering the effect that removal of accounts provisions (“ROAPs”) will have on the treatment of a securitization transaction.⁶⁰ Accounts may experience minor fluctuations; this occurs, for example, when new charges on a credit card exceed payments. Because such increases in the loan pool were not contemplated at the outset of the securitization, the transferor will want to remove accounts in order to decrease the pool and thereby adjust for these fluctuations. ROAPs permit the transferor, under certain conditions and with trustee approval, to withdraw receivables from the portfolio of securitized receivables. In other words, they provide that the transferor may be permitted to select individual credit card, home mortgage, or auto loan accounts from groups of assets that have been transferred to the SPE and then take them back as assets of the transferor. ROAPs typically require that:

- (1) accounts be selected on a random basis;
- (2) the removal be limited to no more than one per month;
- (3) the amount of any one removal be limited to a specified fixed percentage of receivables in the pool;
- (4) the removal cannot materially and adversely affect the interests of an investor; and
- (5) the pool of receivables has specified minimum credit characteristics prior to a proposed removal.⁶¹

57. Discussed *supra* Part I.

58. See Borod, *supra* note 5, at 1-3.

59. See FASB STATEMENT NO. 125, *supra* note 10, at ¶ 13.

60. See Steve Burkholder, *FASB Continues Securitizations Struggle, But Makes Limited Progress on ROAPs*, DAILY TAX REP. (BNA), Jan. 28, 1999, at G-6.

61. FASB Emerging Issues Task Force Issue Summary No. 90-18, Removal of Accounts Provisions in Sales of Credit Card Receivables.

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ROAPs are most commonly seen in credit card securitizations; the credit card industry strongly argues that the existence of ROAPs should not preclude sale treatment.⁶²

The existence of ROAPs in a securitization transaction calls into question whether the transferor has actually relinquished control of the transferred assets. When the transferor retains an interest in the assets through a ROAP, the transfer does not appear to be a sale and beneficial accounting treatment should not be granted.⁶³ The Emerging Issues Task Force of the FASB (the "EITF") reached consensus on the issue of ROAPs most recently in 1990 when it issued release number 90-18 ("EITF 90-18").⁶⁴ Under EITF 90-18, ROAPs do not preclude sale treatment provided: (1) removal of such individual accounts is within the specified terms of the securitization and cannot reduce the amount the investor has invested in the pool, and (2) the seller's relative percentage interest in the pool is not decreased below that specified by the contractual terms of the securitization.⁶⁵

As a result of the promulgation of FAS 125, the FASB has begun to re-evaluate the effect that ROAPs will have under the new control test. Early in this process, the FASB stated that it anticipated taking a more restrictive approach than the one taken by EITF 90-18.⁶⁶ In August of 1996, the FASB issued a document indicating that the impact of FAS 125 on EITF 90-18 required further analysis because, on its face, ROAPs appear to violate the third prong of the control requirement.⁶⁷ Under the third prong, the transferor cannot maintain effective control by using an agreement that entitles the transferor to repurchase assets that are not readily obtainable.⁶⁸ Because individual accounts might not be considered readily obtainable, ROAPs seem to preclude sale treatment. Until the FASB issues the final amended FAS 125, however, EITF 90-18 continues to govern and ROAPs will not preclude sale-accounting treatment.

The discussions regarding ROAPs may also affect the structure of the SPE. Paragraph 26 of FAS 125 defines a qualifying SPE; cur-

62. See *FASB Move May Jolt Credit Players*, ASSET SALES REP., Jan. 4, 1999 at 1.

63. See Steve Burkholder, *FASB Struggles With Removal of Accounts in Effort to Change Securitizations Rules*, DAILY TAX REP. (BNA), Jan. 14, 1999, at G-3, G-4.

64. See Emerging Issues Task Force No. 90-18, *Effect of a Removal of Accounts Provision on the Accounting for a Credit Card Securitization*, September 7, 1990.

65. See *id.*

66. See ASSET SALES REP., *supra* note 62, at 1.

67. See Johnson, *supra* note 46, at 19-77.

68. See FASB STATEMENT NO. 125, *supra* note 10, ¶ 9.

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rently, it requires only that the SPE have legally-distinct standing and have its activities limited as described above. One proposal, however, is to create a “look through” SPE for the purpose of credit card securitization transactions.⁶⁹ This approach would adopt relatively restrictive conditions on the permitted activities of a “look-through” SPE but make an exception for certain kinds of ROAPs.⁷⁰ Another proposal is to develop a control-based theory permitting sale accounting for ROAPs that allow removal of transferred assets specified by events outside the transferor’s control.⁷¹ For example, a qualifying SPE could be required to sell or distribute transferred assets to parties other than the transferor or its affiliates in response to an event or circumstance outside the control of the transferor that causes, or is expected to cause, those transferred financial assets to decline in fair value.⁷²

The FASB has published a tentative conclusion addressing the ROAP issue. Under the recently issued exposure draft, in order for a transfer to be considered a true sale, the transferor must not “retain effective control over transferred assets through a removal-of-accounts provision (ROAP) or other arrangement that empowers the transferor to unilaterally cause the transferee to return specific assets.”⁷³ In other words, the transferor keeps control over the assets if the transaction allows the transferor unilaterally to remove particular assets, but not if assets are selected randomly or if they are removed only after a third party’s decision whether to act. This requirement has been written into paragraph 9 of FAS 125, which defines what constitutes a “true sale.” Little has been published on the industry’s response to the restrictions on the ROAPs.

The FASB made a wise decision in concluding that most ROAPs do not preclude sale treatment; this decision will facilitate many securitization transactions in the credit card account market. Because the accounts tend to be removed in order to bring the pool back to the size that was contemplated at the outset of the transaction, transferors should be permitted to adjust the pool for these fluctuations. Provided that the removal occurs randomly, the pool of receivables will generally have the same attributes before

69. See *January 27, 1999 Board Meeting*, FASB ACTION ALERT NO. 99-05, Feb. 3, 1999, at 1.

70. See *January 13, 1999 Board Meeting*, FASB ACTION ALERT NO. 99-03, Jan. 20, 1999, at 2.

71. See *id.*

72. See *January 27, 1999 Board Meeting*, *supra* note 69, at 2.

73. See PROPOSED AMENDMENT OF FASB STATEMENT NO. 125, *supra* note 15, at *Issue 3*.

and after removal, minimizing the impact on the investor. Permitting the removal of specific accounts, however, could greatly affect the assets backing the securities owned by investors. Harming the investor, the transferor would be able to manipulate credit quality or remove specific accounts slated to record a gain. In securitizations where specific accounts are removed, sale accounting treatment should be precluded. The exposure draft thus represents a workable balance, allowing many common ROAPs while prohibiting those that truly allow the transferor to maintain control over the assets.

III LEGAL REQUIREMENTS FOR SECURITIZATIONS

The accounting issues governing securitization transactions create legal issues because they require legal judgments about when a transfer of assets constitutes a true sale. These judgments must be rendered with a high degree of certainty. Accordingly, it is crucial that the attorney understand the accounting as well as the legal issues surrounding securitization transactions.

A. *A True Sale: General Rules for Corporations*

The term “securitization” is used to cover a wide spectrum of transactions. At one extreme, a transferor may sell the assets outright, retain no interest or control whatsoever, and sever all ties with the SPE. At this end of the spectrum, there is clearly a release of control and the transaction will be accounted for as a “true sale.” At the other extreme, the transferor may create a secured loan transaction in which the assets will serve as collateral for the loan. Here, the transferor retains full control and a “sale” has not been made. This type of transaction is clearly a loan for the transferor and, with a corresponding liability, will be accounted for as such. At both extremes, the transactions are simple because their accounting will follow their form.⁷⁴

The majority of issues arise in the middle of the spectrum of transactions. Here, the form of the transaction is ambiguous because the transferor desires to retain some control over and interest in the SPE.⁷⁵ In order to address transactions that fall within this middle range, Appendix A to FAS 125 requires a careful evaluation of the facts and circumstances of the securitization transaction.⁷⁶ A

74. See THE ASSET SECURITIZATION HANDBOOK, *supra* note 23, at 250-51.

75. See MOORES & COCCO, *supra* note 47, at 23.

76. See FASB STATEMENT NO. 125, *supra* note 10, ¶ 23.

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transferor cannot conclude that financial assets have been sold unless “the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its affiliates”⁷⁷ The pivotal paragraph in FAS 125 is paragraph 9(a), which states that control of transferred assets has only been surrendered if three conditions have been met, the most important of which is that “[t]he transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership”⁷⁸ Unfortunately for attorneys practicing in this area, there is no definitive judicial authority analyzing the issue of true sale in relation to securitization transactions.⁷⁹ Uniform Commercial Code §9-504 Official Comment 4 leaves the “determination whether a particular assignment constitutes a sale or a transfer for security” to individual courts.⁸⁰ Because property law governs whether rights remain in an asset, each state will decide for itself what constitutes a true sale.⁸¹

One problem in examining how the courts have treated securitization transactions is that no decisions have been issued since the effective date of FAS 125. Under FAS 77, the grant of sale accounting treatment depended mostly upon a declaration of the parties to that effect, which meant that courts could look to accounting treatment to determine whether the assets were remote for bankruptcy purposes. If the parties called the transaction a sale, it was a sale; if they called it a loan, it was a secured borrowing. It is unclear whether courts will change their analysis based on the changes in accounting treatment.

In analyzing securitization transactions, some courts have looked solely to the intention of the parties;⁸² this method has advantages but is problematic. The method fits well with FAS 77 in that both the bankruptcy and the accounting treatment depended

77. *See id.*

78. *See id.* ¶ 9(a). The exposure draft of the amended Statement 125 leaves this language entirely intact.

79. *See* Johnson, *supra* note 46, at 5-35.

80. *See id.*

81. *See* *Butner v. United States*, 440 U.S. 48, 54-55 (1979); Richard F. Kadlick, *Legal Issues in Asset-Based Securities Offerings*, in *NEW DEVELOPMENTS IN SECURITIZATION* 1994, at 289, 292 (PLI Commercial Law and Practice Course Handbook Series No. A-704, 1994).

82. *See, e.g., In re Kassuba*, 562 F.2d 511, 514 (7th Cir. 1977); *In re OMNE Partners II*, 67 B.R. 793, 795 (Bankr. D.N.H. 1986); *Stratford Fin. Corp. v. Finex Corp.*, 367 F.2d 569, 571 (2d Cir. 1966).

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upon the parties' intention. The method creates problems of proof, however, and can be easily manipulated by the parties. As such, truly accurate accounting based on the legal ownership of the assets will not be achieved by looking solely to the parties' intent.

Some courts have regarded intent as only one of several factors to be considered in determining whether the securitization transaction constitutes a true sale or a secured loan.⁸³ Attributes these courts have analyzed include: (1) the existence of recourse for the investors in the SPE; (2) who holds the benefits of ownership; (3) irrevocability; (4) whether there is any commingling of funds; and (5) which party maintains and services the financial assets. Unfortunately, another factor these courts often consider is the accounting treatment of the transaction. Under FAS 125, using accounting treatment to determine whether a true sale has occurred would make the rule entirely circular and would provide no guidance to attorneys evaluating whether assets are remote for bankruptcy purposes.

The Tenth Circuit in particular has been highly criticized, though not yet reversed, for its decision in a case involving true-sale analysis.⁸⁴ Faced with a sale of accounts, the court in *Octagon Gas Systems, Inc. v. Rimmer* applied the provisions of Article 9 of the UCC to determine that the transaction constituted a security interest rather than a true sale.⁸⁵ Applying the court's reasoning, it is unlikely that a transfer of accounts receivable could ever constitute a true sale as opposed to a secured financing.⁸⁶ The *Octagon Gas* decision has been criticized for its application of UCC Article 9 provisions to a sale of accounts receivable because only some of these provisions apply directly to sales of accounts.⁸⁷ As one commentator noted, Article 9 "treats the sale of accounts . . . as secured transactions solely for the purpose of applying Article 9's rules relating to attachment, perfection and priority, and should not be construed as precluding true sales of accounts."⁸⁸ In other words, the *Octagon Gas* court was mistaken in applying Article 9 to a sale of

83. See *Major's Furniture Mart, Inc. v. Castle Credit Corp.*, 602 F.2d 538 (3d Cir. 1979).

84. *Octagon Gas Sys., Inc. v. Rimmer*, 995 F.2d 948 (10th Cir. 1993).

85. See *id.* at 956.

86. See Steven B. Levine & Anthony L. Gray, *Protecting the Transaction from Bankruptcy and Insolvency Risks*, in *SECURITIZATION: ASSET-BACKED AND MORTGAGE-BACKED SECURITIES* 7-1, 7-25 (Ronald S. Borod ed., 1996).

87. See Kadlick, *supra* note 81, at 297.

88. *Id.*

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accounts because the provisions of Article 9 treat such sales as secured transactions only for the application of particular rules.

The Third Circuit used different reasoning in reaching the same conclusion that a transfer of receivables with full recourse was a secured loan rather than a true sale.⁸⁹ In *Major's Furniture Mart, Inc. v. Castle Credit Corp.*, the court relied on two actions by the transferor: warrants that the sold accounts were legally enforceable and fully collectible, and a provision indemnifying the purchaser for losses arising from failure to pay and breaches of warranties. The court found that the transferor retained too many of the risks of ownership for the transaction to be treated as a true sale.⁹⁰

The servicing provision can be another key factor in analysis of securitization transactions. When the transferor maintains a role in the servicing of the assets, the transaction documents should clearly indicate that the SPE retains ownership of the books, records, and computer files relating to the assets along with some control over the collection activities of the transferor.⁹¹ The transferor's role in servicing the assets and subsequent compensation should also be well-defined and established on an arm's length basis.⁹²

Another key factor in determining whether a true sale has occurred is the structure of the SPE itself. In order for the transaction to constitute a true sale, the SPE should be created specifically for the securitization transaction and should not have any preexisting creditors.⁹³ Additionally, the SPE's powers should be restricted as closely as possible to allow it to enter only into the securitization transaction and other necessary transactions.⁹⁴ Furthermore, the securitized assets should be free of all liens in favor of parties outside of the securitization transaction.⁹⁵ Independent directors appointed to the board of the SPE can make the commencement of a bankruptcy less likely, particularly when their votes are necessary for a bankruptcy filing.⁹⁶ Finally, the founding documents of the SPE should prohibit merger and reorganization of the SPE, and

89. See *Major's Furniture Mart, Inc. v. Castle Credit Corp.*, 602 F.2d 538 (3rd Cir. 1979).

90. See *id.* at 545.

91. See Engel & Koslow, *supra* note 11, at 483.

92. See *id.*

93. See THE COMMITTEE ON BANKRUPTCY AND CORPORATE REORGANIZATION OF THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK, AMERICAN BAR ASSOCIATION, STRUCTURED FINANCING TECHNIQUES 29 (1995).

94. See STANDARD AND POOR'S RATINGS SERVICES, *supra* note 9, at 30-31.

95. See *id.* at 31.

96. See *id.* at 32; Levine & Gray, *supra* note 86, at 7-13.

should include separateness covenants which ensure that the SPE “holds itself out to the world as an independent entity.”⁹⁷

Standard & Poor’s Ratings Services has published a useful list of factors used by many practitioners attempting to determine whether a securitization transaction constitutes a true sale. These factors include the intent of the parties; the extent of transfer of burdens or risk of loss; the extent of the transferor’s post-transfer control over transferred assets; the accounting and tax treatment of the transaction; and notice to third parties.⁹⁸ Standard & Poor’s extensive checklist provides real-world guidance to practitioners designing securitization transactions. Practitioners may not rely on Standard & Poor’s checklist with complete confidence, however, as no court has yet approved it or relied on it in a decision. As a result, determining whether a securitization constitutes a true sale is complicated even for unregulated corporations. As discussed below, however, the analysis is even more complex when heavily regulated financial institutions are the transferors.

B. A True Sale: Special Rules for Banks

Banks and other regulated financial institutions are in the business of lending money and often have a significant portion of their assets in the form of receivables. For this reason, these institutions are often the transferors in securitization transactions. When insured depository institutions⁹⁹ face serious financial difficulties, however, they are not permitted to file as debtors under Chapter 7 or Chapter 11 of the Bankruptcy Code.¹⁰⁰ Instead, when liquidating or winding up an insured depository institution, the Federal Deposit Insurance Corporation (the “FDIC”) is appointed as a receiver or conservator in the case.¹⁰¹ The determination of whether transferred assets have been isolated for the purposes of bankruptcy law is different depending on whether the Bankruptcy Code or the FDIC provisions govern the liquidating entity.

The current version of FAS 125 addresses the issue of securitizations where the transferor is an insured depository institution:

97. See STANDARD AND POOR’S RATINGS SERVICES, *supra* note 9, at 32.

98. See *id.* at 154-56.

99. Insured depository institutions are defined in the United States Code as “any bank or savings association the deposits of which are insured by the Corporation pursuant to this chapter.” 12 U.S.C. § 1813(c)(2) (1994). The Corporation refers to the Federal Deposit Insurance Corporation. See 12 U.S.C. § 1811(a) (1994).

100. See Johnson, *supra* note 46, at 5-180.

101. See *id.*; 12 U.S.C. § 1821(c)(2)(A) (1994).

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in receivership, if the FDIC may repudiate the securitization transaction¹⁰² and reclaim the transferred assets for the bank, the assets are not considered isolated for purposes of bankruptcy and the transaction would not be considered a true sale. If the FDIC is prohibited from reclaiming the assets, however, or alternatively is required to compensate the SPE fully for the assets taken back, the transaction would fit the requirements of a true sale and the bank would receive favorable accounting treatment. By contrast, the original FAS 125 states that assets transferred by a bank can only be obtained by the FDIC in a receivership proceeding if the SPE investors are made *completely* whole; this means that investors must be compensated for *all* economic benefits contained in the transferred assets.¹⁰³ The FASB originally believed, however, that in receivership proceedings, the FDIC was required to pay principal and interest to the SPE as of the *date of the payment* of those funds.¹⁰⁴ In actuality, when repudiating a contract, the FDIC is required to pay principal and interest only as of the date of the appointment of a receiver,¹⁰⁵ which can be up to 180 days prior to the date of payment.¹⁰⁶

The potential lack of compensation for the SPE for time elapsed between the appointment of the receiver and the date of payment led constituents to seek further explanation from the FASB as to how paragraph 9(a) of FAS 125 applied when an insured financial institution is subject to possible receivership by the FDIC.¹⁰⁷ The FASB decided to take the issue under consideration in its re-evaluation of FAS 125; initially, it concluded that the lack of compensation for the SPE for the time between the appointment of a receiver and the date of payment was significant enough to preclude sale accounting treatment.¹⁰⁸ This conclusion was based on two considerations: the FASB did not want to weaken the standard

102. See 12 U.S.C. § 1821(e) (1994) (concerning the FDIC's powers to repudiate contracts entered into before appointment of conservator or receiver). The FDIC is permitted to repudiate provided the troubled institution is a party to the contract, the FDIC determines the performance of the contract is burdensome, and disaffirmance or repudiation will promote the orderly administration of the troubled institution's affairs. This provides the FDIC with broad, but not absolute, power to disaffirm. See Johnson, *supra* note 46, at 5-183.

103. See FASB STATEMENT NO. 125, *supra* note 10, ¶ 58.

104. See Bullen and Heller, *supra* note 35, at 8; PROPOSED AMENDMENT OF FASB STATEMENT NO. 125, *supra* note 15, ¶¶ 13-14.

105. See 12 U.S.C. § 1821(e)(3)(A)(ii)(I) (1994).

106. See PROPOSED AMENDMENT OF FASB STATEMENT NO. 125, *supra* note 15, ¶ 14a.

107. See *id.* ¶ 13.

108. See *id.* ¶ 15.

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of isolation, but it did want to ensure comparability across industries.¹⁰⁹ Unless the SPE received the full amount of principal and interest due on the date of payment, the assets would not be considered isolated for bankruptcy purposes, and the transaction would be accounted for as a secured borrowing.

After the FASB made its initial determination, insured depository institutions, accountants, and other parties involved in securitizations met with representatives of the FDIC to determine whether the FDIC would take any action to alleviate the effect of the FASB's decision.¹¹⁰ There was concern that, if implemented, the decision would effectively preclude a significant majority of bank-as-transferor securitization transactions.¹¹¹ In December of 1998, the FDIC published for public comment the "Statement of Policy Regarding Treatment of Securitizations and Loan Participations After Appointment of the Federal Deposit Insurance Corporation as Conservator or Receiver" (the "Statement of Policy") in order to clarify how the FDIC would treat securitized assets owned by an SPE during the receivership of the transferor.¹¹² According to the Statement of Policy:

Subject to the following conditions, the FDIC will not attempt to reclaim, recover, or recharacterize as property of the institution or the receivership estate (i) in the case of a securitization, the financial assets transferred by the insured depository institution to a special purpose entity in connection with the securitization, or (ii) in the case of a loan participation, the undivided interest transferred to a participant in connection with the loan participation.¹¹³

The conditions included, among others, that sale accounting under GAAP be used for the transaction, that the Statement of Policy would apply only to securitizations and loan participations, and that the Statement of Policy would not limit any other FDIC powers.¹¹⁴

Following the FDIC determination that it would not seek to reclaim assets transferred to an SPE in a securitization transaction,

109. *See id.*

110. *See* Repudiation and Asset-Backed Securitizations and Loan Participations, 63 Fed. Reg. 71,926 (1998) (proposed Dec. 30, 1998).

111. *See* PROPOSED AMENDMENT OF FASB STATEMENT NO. 125, *supra* note 15, ¶ 16.

112. *See* Repudiation and Asset-Backed Securitizations and Loan Participations, 63 Fed. Reg. at 71,926.

113. *Id.* at 71,927.

114. *See id.* at 71,927-28.

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the FASB concluded that no specific guidance was needed regarding transactions where the FDIC would be a potential receiver.¹¹⁵ As published in June of 1999, the exposure draft of FAS 125 omits reference to the FDIC from paragraph 58, which now states:

For entities that are subject to other possible bankruptcy, conservatorship, or other receivership procedures in the United States or other jurisdictions, judgments about whether transferred assets have been isolated need to be made in relation to the powers of bankruptcy courts or trustees, conservators, or receivers in those jurisdictions.¹¹⁶

Response to the Statement of Policy was not entirely favorable. An FDIC statement of policy can be easily amended or appealed, making reliance on any statement of policy problematic.¹¹⁷ More specifically, the Statement of Policy does not address the effect of its own possible amendment or repeal on transactions which were completed prior to amendment or repeal. In a letter to the FDIC, the American Institute of Certified Public Accountants (the "AICPA") commented that

It is our understanding that legal specialists will not be able to render opinions that provide reasonable assurance that the legal isolation requirement is met under the proposed FDIC Statement of Policy because it does not provide that transactions consummated in reliance thereon will not be subject to repudiation on a retroactive basis in the event the Statement of Policy is changed subsequent to its adoption.¹¹⁸

This concern regarding revocation or amendment was also expressed by members of the Committee on Law and Accounting, Section of Business Law of the American Bar Association.¹¹⁹ One member suggested that the FDIC state that any future revocation or modification of the Statement of Policy would not affect the inter-

115. See PROPOSED AMENDMENT OF FASB STATEMENT NO. 125, *supra* note 15, ¶ 16.

116. *Id.* app. C ¶ 58.

117. See Adam M. Tempkin, *FDIC Proposes Rule, Securing Asset Property Rights*, MORTGAGE-BACKED SEC. LETTER, Sept. 6, 1999, at 1.

118. Letter from Deborah D. Lambert, Chair, Auditing Standards Board and Thomas Ray, Director, Audit and Attest Standards, to Robert E. Feldman, Executive Secretary, Federal Deposit Insurance Corporation 1 (Feb. 26, 1999) (on file with author).

119. See Letter from Richard H. Rowe, Chair, Committee on Law and Accounting, Section of Business Law, American Bar Association, to Deborah D. Lambert, Chair, Auditing Standards Board (Feb. 25, 1999) (on file with author).

ests of investors in securitization transactions entered into prior to the revocation or modification.¹²⁰

As a result of these concerns, in September 1999, the FDIC withdrew the Statement of Policy and instead proposed a rule which contains the same substantive provisions as the Statement of Policy.¹²¹ The key difference between them is that the rule, unlike the Statement of Policy, would be written into law and would therefore be binding on the FDIC.¹²² The proposed regulation reads:

The FDIC shall not, by exercise of its authority to disaffirm or repudiate contracts under 12 U.S.C. 1821(e), 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.¹²³

The proposed rule forbids the FDIC from reclaiming assets transferred through a securitization transaction even where the "legal isolation" condition has not been met. If the legal isolation condition is not met, however, the transaction cannot be considered a true sale under FAS 125; whether the FDIC can reclaim the assets is not relevant to the accounting and legal treatment of the transaction. The other conditions required for the proposed rule to apply are not significantly different in the proposed rule than in the Statement of Policy.

Securitization constituents have responded favorably to the proposed rule. They believe it will bring the increased certainty necessary to facilitate accounting for bank-as-transferor securitization transactions as true sales.¹²⁴ Comments on the proposed rule were due by November 8, 1999.¹²⁵ The FDIC adopted the proposed

120. *See id.*

121. In other words, the proposed rule permits FDIC-insured banks to enter into securitization transactions that can be accounted for as sales. *See* Repudiation and Asset-Backed Securitizations and Loan Participations, 64 Fed. Reg. 49,015 (1999).

122. *See* Tempkin, *supra* note 117, at 1.

123. Treatment by the Federal Deposit Insurance Corporation as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection With a Securitization or Participation, 64 Fed. Reg. 48,968, 48,970 (1999) (to be codified at 12 C.F.R. pt. 360) (proposed Sept. 9, 1999).

124. *See* Tempkin, *supra* note 117, at 1.

125. *See supra* note 123, at 48,968.

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rule on August 11, 2000 without drafting the language quoted above.¹²⁶

Because determination of what constitutes a true sale is so difficult for those representing both banks and corporations, accountants and attorneys often struggle to determine the *right* way to structure a securitization transaction. The lack of clarity can affect the attorney in an even greater respect, however, because of the accountant's need for a legal true sale opinion. The discussion below addresses these key issues.

C. Attorney Liability Concerns and the True Sale Opinion

By requiring that there be a "true sale at law" in order for the securitization transaction to receive sale accounting treatment, the FASB effectively has required that an attorney issue a legal opinion stating without reservation that the assets transferred in the transaction may not be reached by the creditors of the seller.¹²⁷ Until recently, accountants and attorneys, through committees of the AICPA and the Bar, contested two separate liability issues involving true sale opinions. First, they disputed the content of this opinion as well as the degree of certainty needed in it, as accountants interpreted FAS 125 to require a "would" and not "should" conclusion.¹²⁸ This heightened degree of certainty could drastically increase the attorney's liability for statements made in such an opinion, as an attorney cannot predict, with certainty, what a bankruptcy court will do in a specific situation. The second liability issue for attorneys arose from the possibility of a privity relationship between the attorneys and the auditors, which might be created if the accountants shared opinion letters with the company's auditors.¹²⁹

The first issue, the degree of certainty required in the opinion letters, remains a point of contention.¹³⁰ Discussing the scope of and certainty needed in opinion letters, Statement of Auditing Standards No. 73 details the procedures that accountants use in em-

126. See Treatment by the Federal Deposit Insurance Corporation as Conservator or Receiver of Financial Assets Transferred by a Licensed Depository Institution in Connection With a Securitization or Participation, 65 Fed. Reg. 49189 (adopting binding rule effective September 11, 2000, to be codified at 12 C.F.R. pt. 360).

127. See Walter G. McNeill and Daniel J. Mette, *Accounting for Securitizations Under FAS 125: Why Lawyers are Writing About it*, BANKING L.J., Sept. 1997, at 716, 717-18.

128. See *id.* at 718.

129. See *Is it a True Sale?*, BUS. LAW TODAY, Mar./Apr. 1999, at 64.

130. See Johnson, *supra* note 46, at 19-15; McNeill & Mette, *supra* note 127, at 718.

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ploying specialists; while attorneys are not considered specialists when providing litigation or claims services, they are considered specialists when providing more focused assistance as to specific legal issues.¹³¹ A late 1998 amendment to the interpretation of AU 336 by the Auditing Standards Board describes the use of legal interpretations as evidence to support management's assertion that a transfer of financial assets has met the isolation criterion in paragraph 9(a) of FAS No. 125.¹³² The interpretation provides an example of a properly worded legal opinion:

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

[W]e are of the opinion that in a properly presented and argued case, as a legal matter, in a proceeding under the U.S. Bankruptcy Code, in which the Seller is a Debtor, a court *would not* grant an order consolidating the assets and liabilities of the Purchaser with those of the Seller¹³³

The use of the phrase "would be" indicates the highest level of assurance an attorney is able to provide on the issue of isolation of assets.¹³⁴ The AICPA thus requires that an attorney state with virtual certainty that a particular transfer places the assets beyond the reach of a bankruptcy trustee in order for the auditor to permit the use of sale accounting treatment. Even if the lawyer could state that he was "almost certain" as to how a bankruptcy court would rule, in itself a high level of assurance, the auditor would not rely on the opinion and would have insufficient evidence that the accounting should be treated as a sale.

Because of the substantial risk of liability assumed by the lawyer in issuing a "would be" opinion, some critics have proposed that an "either . . . or" legal opinion would provide sufficient audit evi-

131. See CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, Statement on Auditing Standards No. 73, § 336.2 (American Inst. of Certified Pub. Accountants 1994).

132. See KPMG PEAT MARWICK LLP, *Auditing Interpretations Relating to SFAS 125 Transactions*, Professional Practice Letter 98-065, August 14, 1998 at 1.

133. CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, Statement on Auditing Standards No. 73, § 9336.1.13 (American Inst. of Certified Pub. Accountants 1994) (emphasis added) (footnote omitted).

134. See Johnson, *supra* note 46, at 19-15.

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dence.¹³⁵ In an “either . . . or” opinion, the lawyer states that the transaction either constitutes a true sale at law or that it creates a security interest in the assets transferred. The advantage of such an opinion is that the lawyer avoids stating the legal conclusion that a bankruptcy court would reach a certain result, and must merely attest to whether there has been a true sale.

Despite the arguments for “either . . . or” opinions, the Auditing Standards Board interpretation of Auditing Standard No. 73 (the “ASB interpretation”) requires that attorneys provide a high degree of certainty in a true sale opinion. The ASB interpretation states that “[a] legal opinion that includes an inadequate opinion or a disclaimer of opinion . . . does not provide persuasive evidence to support the entity’s assertion”¹³⁶ The opinion cannot rely on such conservative phrases as “it appears,” “there is a reasonable basis to conclude that,” “in our opinion, it is more likely than not that,” or “in our opinion, it is probable that.”¹³⁷ The prohibition on these types of phrases places tremendous pressure on the attorney, and likely requires the attorney to overcompensate in the structuring of the transaction to give the transferor virtually no control over the assets in order to satisfy the accountant’s concerns.

With respect to the second liability issue, the recent Auditing Standards Board interpretation makes real progress. Historically, attorneys have not been held liable to third parties for third party reliance on opinions issued to clients when the attorney and the third party are not in privity.¹³⁸ When the client consents to the third party’s reliance and use of the opinion, however, the third party might have standing to bring suit against the attorney.¹³⁹ The attorney’s concern about the creation of an attorney-client relationship upon the auditor’s use of the legal opinion as evidence of the accounting treatment has been assuaged by the AICPA’s approval of the following language:

Notwithstanding any language to the contrary in our opinions of even date with respect to certain bankruptcy issues relating to the above-referenced transaction, you are authorized to make available to your auditors such opinions solely as evidential matter in support of their evaluation of management’s as-

135. See McNeill & Mette, *supra* note 127, at 717.

136. See Statement on Auditing Standards No. 73, *supra* note 131, § 9336.1.14.

137. *Id.*

138. See Ronald E. Mallen, *Duty to Nonclients: Exploring the Boundaries*, 37 S. TEX. L. REV. 1147, 1157 (1996).

139. See *id.*; Richard R. Howe, *The Duties and Liabilities of Attorneys in Rendering Legal Opinions*, 1989 COLUM. BUS. L. REV. 283, 291-92 (1989).

sertion that the transfer of the receivables meets the isolation criterion of SFAS 125, provided a copy of this letter is furnished to them in connection therewith. In authorizing you to make copies of such opinions available to your auditors for such purpose, we are not undertaking or assuming any duty or obligation to your auditors or establishing any lawyer-client relationship with them. Further, we do not undertake or assume any responsibility with respect to financial statements of you or your affiliates.¹⁴⁰

Permitting the use of this language in the opinion letter should be sufficient to fend off a charge of attorney-client relationship between the transferor's attorney and the transferor's auditors.

Unfortunately, the complexity and confusion regarding the definition of a true sale in securitization transactions overrides the specific concerns of attorneys issuing these opinion letters.¹⁴¹ In practice, law firms rendering true sale opinions typically take the position that retention by the transferor of significant risk of loss in the form of recourse for credit losses makes it difficult to render a true sale opinion.¹⁴² As such, if risk of loss is the key to determining whether a transfer is a true sale in practice, the focus on control seems misplaced. The practical result is that transfers are considered sales when the attorneys are prepared to state that they are, even though it is widely accepted that there is considerable legal uncertainty as to what constitutes a true sale.

CONCLUSION

There is little doubt that the Financial Accounting Standards Board understands the complexity of these issues. The FASB commissioned the Financial Instruments Task Force in 1996, providing a full staff to research and draft provisions related to securitization transactions. The ensuing years of confusion and the issuance of three separate drafts of the Implementation Guide provide an indication of the difficulty and complexity of this topic. The legal and accounting professions anxiously await the final results so they can begin analysis of how they will change the nature of securitization work.

The exposure draft is a good start and resolves many of the issues that remained unclear following the issuance of the original

140. See Statement on Auditing Standards No. 73, *supra* note 131, § 9336.17 (footnote omitted).

141. See *supra* Part III(A) for discussion of the concept of a true legal sale.

142. See McNeill & Mette, *supra* note 127, at 718.

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FAS 125. Its clarification of a qualified SPE and of when ROAPs will preclude sale accounting reflect the economics of securitization transactions. The resolution of the FDIC issue provides clear guidance to regulated financial institutions that their securitization transactions can be accounted for as true sales. The FASB fell short, however, in failing to amend the pivotal paragraph 9(a) and requiring attorneys and accountants to sort out for themselves when assets are truly isolated for purposes of bankruptcy law. Further complicating the issue, the bankruptcy law itself is unclear, and courts have never evaluated the true sale doctrine as applied to securitized assets. For the near future, these difficulties mean that professionals will be required to operate in the dark when determining whether off-balance sheet financing can receive the benefits of sale accounting.

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