Project **Derecognition – Financial Instruments**

Topic **Bankruptcy Remoteness Concept**

Contents and purpose of this paper

1. In course of recent discussions, some board members expressed concerns about lack of sufficient discussion at the Board with respect to bankruptcy remoteness concept (legal isolation test). Those board members are troubled by the situations in which a transferee recognises a transferred financial asset on its books but, if the transferor were to go into receivership, that asset would have to be returned and replaced with an unsecured or a secured claim on the (possibly insolvent) transferor.

2. Some board members also noted that legal isolation is the central focus in deciding whether to derecognise a financial asset under FASB Statement No.166 *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140* (FAS 166).[1] Under that approach a transfer must be bankruptcy remote for an asset or component of an asset to be eligible for derecognition as a result of the transfer. Those board members noted that a further analysis of that concept will be useful in the board's discussion with the FASB in moving towards convergence of the derecognition requirements.

3. This paper analyses the issue of legal isolation and whether or not that concept should be reflected in the derecognition approach for financial assets going forward.

[1] Statement No. 140 is codified in ASC 860. However, that ASC has not been updated for FAS 166.

4. **The staff notes that the analysis in this paper is based on how transfer transactions might be treated in common law jurisdictions. The staff has not considered how transfer transactions might be treated under non common law legal frameworks.**

The Issue

5. The main concern of the legal isolation concept is that the asset that the transferee acquires from the transferor could be upset (reversed), particularly in the event that the transferor becomes subject to insolvency proceedings. Of primary concern is that the asset may have to be re-vested in the transferor. The areas of risk cover (a) substantive non-consolidation, (b) fraudulent transfer and (c) recharacterisation of the sale of the assets as a lending (may be secured) transaction. The consequence of this is that the transferred asset would have to be returned and replaced with an unsecured or secured claim on the financially weak transferor or a bigger (but relatively weak) consolidated entity.
6. Thus under FAS 166, a transferor is required to obtain a legal opinion to confirm that the transferred assets have been shielded from these bankruptcy risks.

Sale under value or fraudulent transfer

7. A fraudulent sale argument stands on whether the disposal of the asset by the transferor amounted to a transaction at an undervalue (particularly relevant if there is over collateralisation provided by the transferor) or that the transferor did not enter into the transaction in good faith and for the purpose of carrying on its business and that the transaction was not to the benefit of the transferor.
8. In practice a liquidator or administrator of a company is entitled to challenge before the court a transaction as being one at an undervalue if it occurred within a relevant time (a specified period before the onset of the insolvency proceedings or if the company was insolvent at the time of the transaction or became insolvent in consequence of the transaction).

9. The transaction will be at an undervalue if either the transaction was a gift by the transferor or if the value of the consideration that it was to receive for the transaction was significantly less than the value provided. The court may make such order as it thinks fit to restore the position to the pre transaction position. However the transaction will be saved if the court is satisfied, first, that the company entered into the transaction in good faith and for the purpose of carrying on its business, and secondly, that at the time it entered into the transaction, there were reasonable grounds for believing that the transaction would benefit the company (transferor).

10. Whilst the transferor may not have received the whole of the consideration *at* the outset, the arrangement would provide for it to receive the whole of the consideration at the outset, as the agreement would provide for it to receive the deferred element of the consideration in the future.

11. The issue of fraudulent sale is applicable to all sale arrangements (whether the asset in question is financial or non financial). Based on the reason given in paragraph 10 the staff does not believe this is a major accounting concern and we do not discuss the issue further in this paper.

Substantive non-consolidation

12. In insolvency of the transferor, the courts may use equitable powers to consolidated related entities and treat the assets and liabilities of such parties as one pool. This enables the creditors of the formerly separate entities to reach the assets of the consolidated pool. Such a consolidation would be an advantage to creditors of a less solvent entity and a disadvantage to the creditors of a more solvent entity (for example the transferee).

13. The substantive consolidation of the transferee (usually an SPE) with any of its shareholders or beneficial interest holders and/or affiliates would defeat one of the major premises of a structured finance transaction, which allows investors to look to segregated assets to generate the payments on their investment.

14. The staff believes this is more of a consolidation issue as opposed to a derecognition issue and hence we do not analyse the issue further.

Recharacterisation of a sale transaction as a financing arrangement

15. The asset that the transferee acquires from the transferor could be upset, in the event that the transferor becomes subject to insolvency proceedings (if the courts recharacterise the sale transaction as a financing arrangement).

16. If a court determines that the transfer was a true sale, then the transferee retains all of the legal and equitable interests in the assets, and thus the court will not include the assets in the transferor's assets. Conversely, if a court determines that the transfer of the assets constitutes a loan; this may result in a security interest that was never perfected.

17. The consequence of a determination that the transaction constitutes a financing arrangement is that the transferred asset would have to be returned and replaced with an unsecured or unsecured claim on the financially weak transferor.

18. This would preserve for the benefit of the bankruptcy estate particular rights in those assets notwithstanding the transferee's security interest. In the first place, the automatic stay would prevent the transferee and its beneficial interest holders from exercising remedies against those assets. As a result of the automatic stay, a secured creditor in an insolvency case is typically compelled to wait a long time before realising value on its secured claim. A secured creditor however has the right to have the stay lifted if its interest is not adequately protected.

19. A second impairment that can be imposed by the court on sales recharacterised as a secured loan to the transferor is that the bankruptcy estate would have the right to use the cash collections received on the collateral, so long as the secured creditor's interest is adequately protected. This is perhaps the most consequential of the rights the transferor is granted in such situations, as the bankruptcy estate is typically short of cash and collections of such collateral can be used to addressed such cash flow needs, subject only to the constraint of providing the secured creditor adequate protection - which might be done by grant of a replacement security over some illiquid substitute asset, or even by doing nothing at all, if there is a sufficient equity cushion in the collateral.

20. Determination of whether an asset transfer is a true sale or a disguised loan is not governed by a statutory rule. It is an equitable determination made by the courts based upon a variety of factors.

21. The primary factors analysed in a true sale opinion include the level of recourse to the transferor, the amount of control retained by the transferor and whether reasonably equivalent value was given for the transfer of the mortgaged property. The less recourse and discretionary control a transferor retains, the more likely it is that a court will consider the transfer to be a true sale. More specifically, the courts have considered the following factors in determining whether a transaction was a true sale:

    (a) the seller/transferor's transfer of the risk of loss related to the asset;

    (b) the absence of post-sale adjustments to the purchase price which requires the transferor/seller to forfeit a portion of proceeds already received from the sale of the asset;

    (c) the intent of the parties to effect a sale, which is determined by the parties' conduct, characteristics of the transaction and sale documentation;

    (d) the transfer of ownership benefits to the SPE;

    (e) the degree of the transferor's post-transfer control over the asset;

    (f) treatment as a sale for accounting and tax purposes;

    (g) notification of underlying obligors;

    (h) substitution of assets; and

    (i) whether the transfer pricing is akin to a loan interest

22. The following analysis focuses solely on the recharacterisation issues.

Practical application issues

23. Some respondents to the Derecognition ED noted that whether or not a transfer achieves bankruptcy remoteness is considered by the markets and rating agencies to be a significant matter and that the pricing of the transfer (or the rating of the transferee) reflect such considerations. In their view a derecognition framework that ignores the notion is not fully reflecting the economics of the market place.

24. Some board members also questioned how the transferee can claim to have an asset if, in bankruptcy, another party can claim the asset from the transferee (to pay its own liabilities for example) without the transferee's consent.

25. As noted in paragraph 20, the determination of whether an asset transfer is a true sale or a disguised loan is not governed by a statutory rule. It is an equitable determination made by the courts based upon a variety of factors. Hence the only authoritative source for analysing this concept are previous court cases and judgements (precedents).

26. The staff notes that cases involving the recharacterisation issue have been thin for decades and that the body of case law is remarkable for its incoherence, to the degree that some judges have thrown up their hands and declared that the state of precedent is such that they might as well toss a coin to decide such cases – "With no discernable rule of law or analytical approach evident from the decisions, a court could flip a coin and find no support in the case law for a decision either way".[2] [3]

27. Consequently, there is diversity in practice (among lawyers) as to what constitutes a true sale under law. This means two transactions with identical fact patterns might be treated differently if the legal opinion obtained differ. This fact was alluded to by FASB in the basis for FAS 166 -

> "In developing Statements 125 and 140, the Board concluded that the isolation condition is an important consideration in deciding whether to derecognise a financial asset. The Board acknowledged that a transferor would likely need to rely on a legal analysis of what would happen if the transferor enters bankruptcy or receivership. **Several Board members observed that attorneys, including those who commented on the 2003 and 2005 Exposure Drafts on qualifying special-purpose entities and transfers of financial assets, do not always agree on whether a particular transaction meets the requirements for a true sale opinion.** The nature of these opinions is described in paragraph 27A of Statement 140, as amended by this Statement. To provide a true sale opinion, an attorney must evaluate the facts and circumstances of a particular transaction and make a reasoned judgment about how a court would view the transferred financial assets on the basis of applicable statutory, common, and case laws that

[2] See In re Commercial Loan Corp., 316 B.R. 690, 700 (Bankr. N.D. Ill. 2004)

[3] True sale , like true love, is sadly elusive – K.C Kethering in True sale of receivables: a purposive analysis

are relevant to the transaction. **<u>The Board is aware that attorneys may reach different conclusions about similar transactions because they may assess the facts and circumstances of a particular transaction differently or may interpret the law differently.</u>** During its redeliberations, the Board considered information (provided by attorneys, auditors, and regulators of financial institutions) describing the key characteristics that attorneys consider in rendering true sale and nonconsolidation opinions." ***FAS 166 Paragraph A37 (emphasis added)***

28. In the light of the interpretation difficulties and the likely diversity in practice, the FASB considered replacing the legal isolation test with an accounting analysis in developing FAS 166 but it decided to revisit that issue as part of the work with the IASB to develop a converged solution for accounting for transfer of financial assets -

"The Board also discussed whether it would be more meaningful to provide an accounting definition of isolation that did not rely on a legal analysis. The Board rejected that proposal because it believes that the isolation principle is a fundamental cornerstone of Statement 140 that should be revised only in the context of a project to completely revisit the topic of derecognition. The Board decided that such a fundamental project should be conducted jointly with the IASB." ***FAS 166 Paragraph A42***

How should uncertainties be addressed in financial reporting

29. The staff does not agree with the comments that a derecognition approach that does not include a legal isolation test is flawed.

30. Paragraph 37 of the *Framework*, the Board acknowledges that preparers of financial statements have to contend with the uncertainties that inevitably surround many events and circumstances, such as the collectability of doubtful receivables, the probable useful life of plant and equipment and the number of warranty claims that may occur. <u>It explains that such uncertainties are recognised by the disclosure of their nature and extent and by the exercise of prudence in the preparation of the financial statements.</u>

31. <u>Paragraph 37 of the *Framework* defines prudence as the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty</u>, such that assets or income are not overstated and liabilities or expenses are not understated. In the same paragraph,

the Board also explains that the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because by so doing the financial statements would not be neutral and, therefore, not have the quality of reliability.

32. Moreover, in paragraph 21 of the Framework, the Board explains that in addition to the elements of financial statements, financial statements also contain notes and supplementary schedules and other information. <u>For example, they may contain additional information that is relevant to the needs of users about the items in the balance sheet and income statement such as disclosures about the risks and uncertainties affecting the entity,</u> information about geographical and industry segments and the effect on the entity of changing prices**.**

33. The staff notes that bankruptcy remoteness plays a role in the pricing of a transfer and that information about transfers that are not bankruptcy remote is important to a transferee if there is more than a remote possibility of the transferor going into receivership (and hence that uncertainty ought to be disclosed).

34. The staff believes that, to the extent that such a recharacterisation applies only in bankruptcy of the transferor, then such an occurrence is no different from any other uncertainty that attaches to assets in general (for example right of return and product warranties). Based on the Framework, the staff believes that this possibility should be reflected in the pricing of the asset on the books of the transferee (which is consistent with the approach adopted by many rating agencies) and such risks should be adequately disclosed in the notes to the financial statement.

What is an asset under the Framework?

35. The staff notes that under the current definitions (and working definition) of an asset, <u>**only present ability**</u> to obtain future economic benefits is an asset under

the definition. ‘Present’ means that on the date of the financial statements the entity has the right or other access to the controls the economic benefits.

36. Hence, the staff believes that an entity has no asset for a particular future economic benefit if the entity would have access to and control of the benefit in the future. Also, an entity is considered still to have an asset if the entity’s access to and control of the economic benefit would be removed, but the event that would remove its access or control of the economic benefits is in the future.

37. Similarly, the staff believes that an ability to get access to a financial asset’s cash flows that is conditioned on something else is not equivalent to having control over that asset. Accordingly, the right to get access is not the same as a right entitling the entity access now to the cash flows or other economic benefits.

38. The staff believes that the possibility of recharacterisation is an attached implicit call option and not dissimilar to a transfer of an asset with an explicit call to repurchase the asset in the future (or contingent on insolvency).

Property Rights

39. Under the Framework, an asset is defined to represent a bundle of rights and the definition of ownership thereof as ‘full control’ over the economic benefits associated with those rights. An asset is, therefore, a bundle of rights over resources that the owner is free to exercise and whose exercise is protected from interference by others.

40. The legal isolation analysis is based on the notion that an asset is a fully defined object (complete property right) whose primary characteristic is that of securing full control over resources (with stability of expectations). Complete property rights imply owners’ abilities to effectively exclude non-owners from interfering with well-defined rights in all their relevant attributes.

41. Property rights, however, are not fully definable at the outset of a transaction. Firstly, there are an indefinite numbers of possible disputes between the parties to the transaction that may arise before or after the completion of a transaction. Incompleteness of property rights can also arise from uncertainty over the enforcement of property rights. The process of completion of the specification

of the property evolves over time as enforcement problems are addressed or the right becomes more defined. The decision of a court, the process of legislation and public regulation, as well as private orderings all constitute means through which such rival claims might be solved.

42. The staff believes that property is a bundle of defined and presumptive rights, with the latter potentially exposed to an externality (a rival claim). Defined and enforceable rights constitute the core of ownership rights at any given time. The presumptive rights that do not belong to the core are part of the total rights until another party exercises an opposed presumptive right over the underlying economic benefits.

43. The staff believes that when rights are not well defined or when they are poorly enforced they do not dispute the access of the party with the right to the economic benefits of the asset but rather they imply a decrease in the asset's value.

Staff Recommendation

44. Based on the analysis in this paper, the staff does not recommend an inclusion of a legal isolation (bankruptcy remoteness) test in the derecognition approach being developed by the Board.

Question for the Board:

a) Does the Board agree with the staff that bankruptcy remoteness (legal isolation criteria) concept **should not be** included in the derecognition approach?

b) If not, what are the conceptual reasons why bankruptcy remoteness (legal isolation) should matter for the derecognition analysis and what approach do you suggest to address this issue?