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Client Alert

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FASB Issues Exposure Draft Proposing FAS 140 Amendments—Legal Perspective

> "The amendments to FAS 140 proposed in the exposure draft may have a significant effect on structures that currently qualify for sale accounting treatment under FAS 140."

On June 10, the Financial Accounting Standards Board (FASB) issued an exposure draft proposing amendments to Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities* (FAS 140). FAS 140 establishes the standards to determine whether sale accounting treatment is permitted for securitizations and other transfers of financial assets. If sale accounting treatment is permitted, the transferred assets and associated liabilities are removed from the balance sheet of the transferor so long as the transferee is not required to be consolidated with the transferor.

In this *Client Alert*, we discuss some of the legal structuring issues raised by the FAS 140 exposure draft. However, accountants should be consulted for a more complete understanding and interpretation of FAS 140, the proposed amendments, and any final amendments, if adopted. Companies should also consult their accountants as to the proper application of these rules to any particular transaction.

Overview

FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* (FIN 46), creates a new set of rules to govern whether variable interest entities should be consolidated with their primary beneficiaries.[1] Many of the special purpose entities, or "SPEs," used to securitize assets are considered to be variable interest entities under FIN 46. However, FIN 46 specifically provides that SPEs that meet the requirements of FAS 140 for qualifying special purpose entities, or "QSPEs," are not required to be consolidated with any other entity. FASB has indicated that the exception for QSPEs in FIN 46 both focused more attention by FASB on the reissuance of beneficial interests by QSPEs and created an incentive to use QSPEs to avoid consolidation. The amendments in the exposure draft were proposed in response.

The amendments seek to achieve the following goals:

- to limit the relationships a transferor of financial assets, its affiliates and its agents can have with a QSPE,
- to prohibit any party from enhancing or protecting the value of its interest in a QSPE by providing financial support to the QSPE or making decisions about reissuing beneficial interests in the QSPE,
- to prohibit a QSPE from holding equity instruments, and
- to clarify the requirements for financial assets held by a QSPE that mature after the termination date of the entity.

They also provide that a transferor using a two-step transfer to legally

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isolate the assets from its insolvency risk must use a QSPE in the second step to achieve sale accounting treatment. Finally, they extend certain restrictions that formerly applied only to the transferor so that those restrictions would apply to all consolidated affiliates of the transferor, other than certain bankruptcy-remote SPEs.

The amendments, if adopted in their current form, could cause significant changes in accounting for and structuring securitization transactions. The scope and intent of many of these provisions is also unclear. Entities that are QSPEs under the current standards of FAS 140, but that do not meet the requirements of the amendments, will be permitted to retain their QSPE status only so long as, after the effective date of the amendments, they do not issue new beneficial interests and do not receive assets other than those they were previously committed to receive (based on commitments to unaffiliated beneficial interest holders). The amendments will become effective for public entities on the first day of the first fiscal quarter after they become final and for private entities on the first day of the first fiscal year after they become final. We provide a more detailed discussion below.

Reissuance of Beneficial Interests Restricted for QSPEs

One of the primary areas on which FASB has focused in the exposure draft is the reissuance of beneficial interests by QSPEs. Under FAS 140, a beneficial interest can be either a debt or equity interest that entitles the holder to receive cash payments from a specified pool of financial assets. Many types of beneficial interests issued by QSPEs are paid only from these cash payments of financial assets. Some short-term obligations, such as commercial paper, although supported by a pool of financial assets, may be paid from the proceeds of sales of additional short-term obligations.

To qualify for sale accounting treatment under paragraph 9 of FAS 140, the transferor of the financial assets must have surrendered control of them. The ability to pay certain beneficial interests in the assets by issuing new beneficial interests, rather than by passing through collections of the financial assets, FASB says, indicates that the SPE is “effectively pledging and repledging” the transferred assets. This in turn, FASB states, raises questions as to whether the transferor has effectively surrendered control of the transferred assets.

In response, proposed paragraph 35f provides that if the SPE has the ability to reissue beneficial interests, three additional conditions must be met in order for the SPE to be a QSPE:

1. A party, its affiliates or its agents cannot commit to deliver additional cash or other assets to the SPE if such commitments represent more than the aggregate fair market value of all commitments to transfer additional cash or assets to the SPE;
2. A party, its affiliates or its agents cannot both (a) make decisions about reissuing beneficial interests and (b) either enter into a commitment to deliver additional cash or other assets to the SPE or hold beneficial interests other than the most senior in priority; and
3. If a party, its affiliates or its agents holds beneficial interests other than the most senior in priority, it cannot commit to deliver additional cash or other assets to the SPEs.

These provisions are particularly troubling for transferors that use revolving master-trust type structures in which beneficial interests may be issued at various points in time throughout the life of the vehicle. Some of these structures do issue commercial paper or other short-term obligations that are apparently intended to fall within the scope of these provisions, but it is not clear, for instance, whether the issuance of new beneficial interests after previously issued beneficial interests

of the vehicle have been paid in full would also constitute "reissuance" under these provisions.

FASB also has not provided guidance about what it means by some of the other terms used in this provision. Do "beneficial interests other than the most senior in priority" include residual interests retained by the transferor (or an intermediate SPE)? Such residual interests often receive cash flow allocations at the same priority level as senior third-party beneficial interests, which would suggest that they are senior, but may also include the right to receive "excess spread" (the excess cash flows not needed to make agreed payments to third-party beneficial holders), which may not be considered a senior interest. And what does FASB mean when it refers to commitments to deliver additional cash or other assets to the SPE? In its proposed new paragraph 35e (discussed below), it includes a specific carveout for forward commitments in revolving structure securitizations (*i.e.*, the transferor agrees to transfer all receivables in particular accounts, whether those receivables exist at the time of transfer or are subsequently created). In proposed paragraph 35f, that carveout for revolving structures is omitted, and so it is possible that the commitments to make daily transfers of receivables in these structures are "commitments to deliver cash or other assets to the SPE" for these purposes. It is not clear whether this was intentional or whether the absence of the carveout is an oversight.

Provision of Financial Support to QSPEs by Transferor would be Restricted

Proposed new paragraph 35e would prohibit QSPEs from entering agreements to receive cash or additional financial assets from the transferor, its affiliates and its agents, other than forward commitments in revolving structure securitizations. These arrangements include liquidity agreements, guarantees, options, total return swaps, agreements to purchase beneficial interests directly or indirectly from beneficial interest holders and other types of arrangements, even if such arrangements are contingent or conditional. For QSPEs in which the transferor agrees to maintain a specified level of assets, or overcollateralization—often required by the rating agencies as a condition to rating a transaction—this restriction may be particularly problematic. FASB has, however, specifically carved out from the application of paragraph 35e the obligation to make servicing advances, so long as the servicer can choose not to make the advance if it believes recovery on the advance is in doubt.

Passive Derivatives Cannot Be With Affiliates

Under the new proposal, a QSPE will not be permitted to enter into any derivative agreement with an affiliate of the transferor. QSPEs that already have such arrangements will be allowed to retain their status as QSPEs only so long as they do not issue new beneficial interests. For transferors that use master trusts as their securitization QSPEs and that have included in those master trusts passive derivatives with affiliates, this is a particularly problematic provision. Since the adoption of FAS 140, in our experience these entities generally have been careful to ensure that all derivative agreements with QSPEs are entirely passive, as required by paragraph 35c; as a result, they are unlikely to be able to amend derivative agreements with affiliates to transfer to them to unaffiliated third parties. By complying with the current rules, many sponsors of securitization programs have developed structures that cannot be modified to accommodate the proposed rules, and unless FASB provides relief on this point in the final rule (such as by grandfathering the derivative contracts

themselves), transferors wishing to retain sale accounting treatment may have to abandon these structures.

Two-step Transfers Must Use QSPE As Second Step

Sale accounting treatment is permitted under FAS 140 only to the extent that the transferor has surrendered control of the transferred assets. Among the conditions required for surrender of control are (i) that the assets are legally isolated from the transferor and (ii) that the transferee has the right to pledge or exchange the transferred assets, or if the transferee is a QSPE, the beneficial interest holders in the QSPE have the right to pledge or exchange their beneficial interests. To achieve legal isolation of assets, many transferors use a two-step process in which assets are first transferred to a bankruptcy-remote SPE (often a wholly owned subsidiary of the transferor) in a "true sale" and then retransferred by the SPE in a second step that often is not a true sale because the SPE continues to retain residual interests or have further involvement with the assets. (In some circumstances, such as equipment lease securitizations, the first step may involve a true sale that includes assets that cannot be held by a QSPE, such as the underlying equipment, followed by a second true sale to the QSPE that excludes the nonfinancial assets.) The true sale at the first step (to an entity that would not be consolidated with the transferor in a transferor bankruptcy) is considered sufficient to legally isolate the assets from the bankruptcy risk of the transferor. If the second step involves a transfer of the assets directly to a third party, such that the third party has the right to pledge or exchange the assets, the transferee is not a QSPE. If the second step involves a transfer to another SPE that issues beneficial interests, generally that second transferee would be a QSPE. The proposed amendments indicate that an undivided interest in the assets is considered a beneficial interest.[2] FASB expressed a concern that the failure to use a QSPE in the second step would allow transferors to avoid many of the restrictions FASB is seeking to implement with these amendments because many of these restrictions apply only to QSPEs. It seems likely that many structures will have to convert second-tier SPEs to QSPEs or insert a QSPE as the second step in the chain of transfer to retain sale accounting treatment.

Passive Equity Instruments Not Permitted

In the current version of FAS 140, QSPEs are permitted to invest in equity instruments so long as they are passive, *i.e.*, so long as the QSPE is not permitted to vote the instruments. The proposed amendments would prohibit QSPEs from holding all equity instruments, whether or not passive.

FASB expressed concern that transfers of equity instruments to QSPEs could enable transferors to convert equity instruments to securities designated as available for sale, changing the method of accounting for gains and losses on those instruments. However, FASB has not defined the term "equity instruments." It is not clear whether investments in instruments that have debt-like characteristics but are technically in the form of equity, such as money market shares and trust pass-through certificates, would be permitted.

Assets Must Be Beyond Reach of Consolidated Affiliates

The proposed amendment would change paragraph 9 of FAS 140, which now permits sale accounting treatment only if the transferred assets have been put presumptively beyond the reach of the transferor, to provide that the transferred assets must have been put beyond the reach of a bankruptcy trustee or receiver for the transferor or any consolidated affiliate of the transferor that is not a bankruptcy-

remote SPE. This is a further clarification of a restriction already included in paragraph 27 of FAS 140. Because this highlights an existing provision, it should have little structuring significance. However, it is possible that the change will cause accountants to look for broader nonconsolidation opinions, which could increase the legal costs of transactions.

Method for Selling Assets on Termination of SPE or Maturity of Beneficial Interests Must be Specified at Inception

Some SPEs will continue to own assets at the maturity of the beneficial interests in the SPE, either because the maturities of those assets are longer than the maturity of the beneficial interests or because the SPE continues to acquire assets over time (as in a revolving structure). FAS 140 had previously indicated that sales of assets by an SPE can only occur automatically on fixed or determinable dates that are specified at inception. The amendment would clarify that the method of sale must also be specified at inception and cannot allow discretion as to whether to sell transferred assets to third parties or distribute them to beneficial interest holders.

The amendments to FAS 140 proposed in the exposure draft may have a significant effect on structures that currently qualify for sale accounting treatment under FAS 140. The grandfathering provisions are limited to QSPEs that do not issue new beneficial interests. Transfers of additional assets, even if previously committed, in transactions that currently qualify for sale accounting treatment but do not use a QSPE, will not receive the benefit of these provisions.

Endnotes

[1] Whether an entity constitutes a "Variable Interest Entity" (VIE) for purposes of FIN 46 turns on an analysis of two points: first, whether the total equity investment at risk in the special purpose entity is sufficient to permit the entity to finance its activities without additional subordinated financial support from other parties; and second, whether the equity investors in the entity lack one or more key characteristics, such as the ability to directly or indirectly direct the decisions of the entity, the obligation to absorb the losses of the entity as they occur without receiving some form of loss protection or third-party credit support, and the right to receive, without limitation, the expected residual returns of the entity or its assets if they occur. The "Primary Beneficiary" of a VIE is the holder of variable interests in such entity that will absorb a majority of the entity's expected losses if they occur or, if no variable interest holder is exposed to a majority of the expected losses, the holder that is entitled to receive the majority of the entity's expected returns if they occur. In addition, a direct or indirect ability to make decisions that significantly affect the results of the activities of a VIE is a strong indication under FIN 46 that an enterprise may hold variable interests with characteristics that would require consolidation of the VIE and its assets and liabilities by the decision maker. For further information about the legal structuring issues associated with FIN 46, *see* Latham & Watkins Bulletin No. 287, May 2, 2003, Consolidation of Variable Interest Entities under FASB Interpretation No. 46.

[2] It is not clear whether such an undivided interest would be treated as an "equity instrument." Under the proposed amendments, QSPEs would be prohibited from holding equity instruments, and this characterization could therefore be a further barrier to establishing QSPE status.

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If you have any questions about this *Client Alert*, for further information about the exposure draft or FAS 140, or if you would like assistance in preparing a comment letter to the FASB with respect to these proposals, please contact Ellen Marks at 312-876-7626, Vicki Marmorstein at 213-891-8340, Nancy Schimmel at 312-876-7618 or Laura DeFelice at 212-906-1780. Comments on the proposal must be received by the FASB no later than July 31, 2003.

Boston
617-663-5700

Brussels
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