# ACCOUNTING FOR ASSET SECURITIZATION IN A FULL DISCLOSURE WORLD

*Angela Petrucci**

## I. INTRODUCTION

Newspaper headlines over the past few years have consistently revealed a problem that has become almost endemic to the corporate world: financial accounting scandals arising from fraud and manipulation. Beginning with Enron, followed by WorldCom, Tyco, HealthSouth, and now the latest, the Italian company Parmalat, the investing public and individuals worldwide repeatedly ask what went wrong and how to avert these financial disasters. Although several reasons can explain why these scandals occurred, the use of off-balance sheet transactions often ranks among the list of causes.[1] Off-balance sheet financing—often criticized unfairly—includes a thriving industry known as asset-backed securitizations[2] that continues to grow in dollar volume[3] and in importance to transactional lawyers and the financial capital markets. Asset securitizations can take several forms; however, the term generally refers to a type of financing in which a company identifies a pool of assets with a predictable payment stream and transfers the assets to a third party for the purpose of issuing debt or equity securities to investors willing to invest in those assets.[4]

These highly efficient and extremely technical asset-backed securitization transactions repeatedly raise important legal and accounting questions. In particular, asset securitization requires substantial analysis from both a bankruptcy and accounting perspective because these transactions rely upon a transfer of assets—sometimes between closely-related entities—to assure isolation of the transferred assets from a bankruptcy

* Candidate for J.D., University of Notre Dame Law School, 2005; B.A. University of Notre Dame, 1998. The author would like to thank Professor Matthew Barrett from Notre Dame Law School for all of his generous guidance, time, and assistance from inception to completion of this article. The author would also like to thank James Mountain from Deloitte & Touche, LLP, John Hitt, Jr. from Chapman and Cutler, LLP, and Professor Thomas Plank from the University of Tennessee Law School for their invaluable assistance in their discussions with the author and in reviewing this Note.

1. Andrew Parker, *Finding your way round complexities that concern regulators–Special Purpose Vehicles*, FIN. TIMES, Feb. 10, 2004.

2. The terms "asset-backed securitization," "securitization," "structured finance transaction," "asset securitization," and "asset-backed financing" are all terms for the same concept and are used interchangeably throughout this Note.

3. As of 2002, the total amount of asset-backed securities issued and outstanding exceeded over $1.5 trillion. *See* chart of Asset-backed Securities Outstanding prepared by the Bond Market Association, *at* http://www.bondmarkets.com/Research/absos.shtml (last visited Apr. 15, 2004).

4. Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369, 1373–74 (1991) (acknowledging that definitions typically describe the process and not the type of financing itself). For more description of the mechanics of asset-backed securitization, see *infra* Part III.

of the transferor. The vast majority of the asset securitization transactions satisfy all of the necessary criteria for complete isolation of the assets and function exactly as designed. One should also appreciate why these structures receive criticism, however, to anticipate the changes advocated by both the accounting industry and investors, if for no other reason than to evaluate whether a change is necessary. One hundred percent assurance against fraud can never occur, but one can consider the proper system of checks and balances in light of the various criticisms.

Asset securitization has received substantial criticism on both the bankruptcy and accounting fronts. For instance, in the bankruptcy arena, one piece of legislation regarding what constitutes a sale—later withdrawn after Enron—would have provided a "safe harbor" for asset securitization in the bankruptcy code.[5] On the other side of the bankruptcy spectrum, a bill proposed by Senator Richard Durbin and Representative William Delahunt in Congress—also later withdrawn—sought to protect unsecured creditors of companies, namely employees and retirees, and would have given bankruptcy courts the ability to recharacterize a true sale in a securitization despite the parties' intentions and state laws regarding sales of assets.[6] Notwithstanding the proposed statutes, bankruptcy courts still possess the power to analyze a securitization transaction on a case-by-case basis by employing a true sale assessment and determining whether to impose a substantive consolidation of the entities that essentially renders the securitization ineffective.[7]

On the accounting side of asset securitization transactions, the Financial Accounting Standards Board (FASB)[8] sets the accounting standards for such transactions and revised those standards numerous times during the last several years, first with the adoption of Statement of Financial Accounting Standards No. 125[9] (SFAS 125) (which revised Statement of Financial Accounting Standards No. 77[10] (SFAS 77)), and shortly thereafter with the adoption of Statement of Financial Accounting Standards No. 140[11] (SFAS 140).[12] The resulting accounting standard governing many of the asset securitizations, however, represents somewhat of a departure from traditional accounting fun-

5. *See* Bankruptcy Reform Act of 2001, S. 220, 107th Cong. § 912 (2001); H.R. 333, 107th Cong. § 912 (2001).

6. *See generally* Employee Abuse Prevention Act, S. 2798, H.R. 5221 107th Cong. (2002).

7. *See infra* Part III.

8. Pursuant to §108 of Sarbanes-Oxley, Congress specifically delegated the authority to the Securities and Exchange Commission (SEC) "to establish criteria that must be met in order for the work product of an accounting standard-setting body to be recognized as 'generally accepted.'" Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 §108, 116 Stat. 745 (codified in scattered sections of 15, 18, 28 and 29 U.S.C.A. (West Supp. 2002)). In carrying out this authority, the SEC could recognize as "generally accepted" any principles by a private standard-setting body for the purposes of its securities laws so long as the standard-setter is organized as a private entity, has a board of trustees, is funded as provided in Section 108 of Sarbanes-Oxley, has adopted procedures to ensure prompt consideration for changing business issues, and considers the need to keep standards current in reflecting changes in the business environment. The SEC reaffirmed the status of the FASB as a Designated Private-Sector Standard Setter in May of 2003. 68 Fed. Reg. 23,333 (May 1, 2003). The SEC determined that the FASB and its parent, the Financial Accounting Foundation ("FAF"), satisfied the appropriate criteria as serving as the private standard-setter for securities law purposes. *Id. See also* DAVID R. HERWITZ & MATTHEW J. BARRETT, ACCOUNTING FOR LAWYERS 139 (3d ed. 2001).

9. *See* ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENTS OF LIABILITIES, Statement of Financial Accounting Standards No. 125 (Financial Accounting Standards Bd. 1996) [hereinafter SFAS 125].

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

11. *See* ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENTS OF LIABILITIES, Statement of Financial Accounting Standards No. 140 (Financial Accounting Standards Bd. 2000) [hereinafter SFAS 140].

12. Frederick Feldkamp, *Accounting rules: saving US structured finance*, 2003 WL 18277240 (2003).

damentals.[13] Instead, SFAS 140 arguably serves as more of a bright-line test, which potentially conflicts with the latest goals to switch to principles-based as opposed to rules-based accounting in providing full and adequate disclosure expressed in the Sarbanes-Oxley Act[14] and, more recently, by the FASB.[15] Although accounting rules do not represent the law, they do guide the structuring of securitization transactions. Thus, an understanding of the tension that exists within these rules provides illustrative guidance as to why financial scandals such as Enron and Parmalat may have occurred and how a change in the standards might impact asset securitization structures. Moreover, in understanding the vulnerability associated with this accounting standard, one can appreciate its potential for manipulation—namely via the use of separate entities—and its corresponding accounting rules to improve the appearance of an operating company's balance sheet and impact its income, cash flows, and ongoing financial performance. A variety of options exist to account for these transactions, each with its associated advantages and disadvantages and each raising the ultimate question of which presentation constitutes the most adequate and fair depiction for all the parties involved.

This Note intends to provide a broad-based overview of the concepts inherent in the asset-backed securitization structure, from both a legal and accounting perspective. Admittedly, the industry of asset securitization encompasses a wide range of transactions, each with its unique intricacies and needs that might not apply to or warrant the criticisms from the bulk of this discussion. By no means does the author intend to address all of the various distinctions between all of the transactions, but instead intends to provide a summary of the major issues that have emerged in the legal and accounting field including the most recent decisions in the accounting industry. Moreover, although the legal analysis plays a significant role in how a court might ultimately treat asset securitizations, most of the current controversy with these transactions presently concerns the accounting characterization and, as such, will remain the primary focus.

Part II of this Note provides a brief overview of how a typical asset-backed securitization operates, while Part III discusses the legal theories of true sale and consolidation as applied by bankruptcy courts and how this affects the legal structure of securitizations. Part IV provides a discussion of accounting, its relationship to law, and an explanation of the tension that exists with respect to the accounting standards themselves and how the accounting guidance for asset securitizations compares to the overarching accounting principles of revenue recognition, asset and liability measurement, and consolidation. Finally, Part V offers a description of the various approaches to accounting for asset securitization used by the industry. This Note concludes by suggesting that the proposed "matched presentation" method advocated by industry participants provides the most suitable compromise.

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13. *See infra* Part IV.
14. Pub. L. No. 107-24, 116 Stat. 745 (West Supp. 2002).
15. *See id.* § 108(d)(1)(A). *See also* PRINCIPLES-BASED APPROACH TO U.S. STANDARD SETTING, Proposal (Financial Accounting Standards Bd. 2002), *available at* http://www.fasb.org/proposals/principles-based_approach.pdf (last visited Apr. 15, 2004) [hereinafter Proposal].

## II. CONCEPTUAL FRAMEWORK OF ASSET-BACKED SECURITIZATION

### A. Overview of Basic Structure

Despite numerous definitions of asset securitization, one suitable definition entails a type of financing where "monetary assets with predictable cash flows are pooled and sold to a specially created third party that has borrowed money to finance the purchase. These borrowed funds are raised through the sale of asset-backed securities, which can take the form of either commercial paper or bonds."[16] The advantage of a securitization—as opposed to a traditional loan secured by accounts receivable or pools of loans—is that an investor will accept a lower interest rate in exchange for the assurance of isolation of the assets from the operating and bankruptcy risks of the originating company.[17] This isolation not only provides lower interest costs for the originating company, but it also enhances a company's overall liquidity, diversifies its funding sources, and can provide for off-balance sheet financing treatment.[18] Entities that typically utilize these financing vehicles include financial service companies seeking to liquidate longer-term loan portfolios, credit card companies with ongoing pools of fluctuating credit card balances, and even Fortune 500 companies with a large pool of trade receivables that seek to borrow at a lower interest rate. A lawyer should also comprehend the distinctions between an asset securitization, in which an investor agrees to look to the collateral and assets as the source of repayment and only secondarily to the originating company (via limited guarantees and assurances) with a secured loan, in which the lender looks primarily to a company's ability and willingness to repay and only secondarily looks to the collateral (assets) for repayment.[19]

For both bankruptcy and accounting purposes, the transfer of assets in a securitization must qualify as a "true sale"[20] of assets to ensure isolation from an originating company's operations.[21] To so qualify, an originating company identifies a pool of assets with a predictable payment stream (such as accounts receivable, credit card receivables, mortgage obligations, or similar loan obligations) and transfers these assets to a separate entity, usually a wholly-owned subsidiary, that qualifies as a special purpose entity (SPE).[22] This "special purpose" description arises because of its limited and specifically

16. W. Alexander Roever, *The Joy of Securitization: Understanding Securitization and its Appeal*, *in* ISSUER PERSPECTIVES ON SECURITIZATION 1, 4 (Frank Fabozzi ed., 1998).

17. *See* Lois R. Lupica, *Asset Securitization: The Unsecured Creditor's Perspective*, 76 TEX. L. REV. 595, 613 (1998).

18. *Id.* at 610–16 (describing the benefits and why firms seek asset securitization).

19. *See* Roever, *supra* note 16, at 4.

20. The definition of a "true sale" can vary under existing legal principles and accounting standards. *See infra* Parts III & IV.

21. *See* Robert Stark, *Viewing the LTV Steel ABS Opinion in its Proper Context*, 27 J. CORP. L. 211, 217 (2002). No official cases have officially challenged the true sale of assets in an asset backed securitization (*see infra* note 50). One case that came extremely close, however, is *In re* LTV Steel, 274 B.R. 278 (Bankr. N.D. Ohio, 2001). In *LTV Steel*, the bankruptcy court upheld an interim order to LTV Steel granting the debtor in possession (DIP) LTV Steel the use of the accounts receivable (cash collateral) sold in a securitization. *Id.* at 287. The court did not make a finding as to whether a true sale had occurred, as a finding as to the property of the estate would have to be made later at an evidentiary hearing; however, the court found that the debtor LTV Steel at least retained an equitable interest in the assets. *Id.* at 285. The creditor, Abbey National (also the investor in the securitization), later reached a settlement with LTV Steel in providing the necessary DIP financing before the hearing for the final order granting the debtor use of the assets, therefore the court never made an evidentiary finding with regard to a true sale in this securitization. *See* Stark, *supra* note 21, at 223.

22. The industry currently uses the terms "SPE" and "SPV" (special purpose vehicle) to refer to the same

defined functions, clearly distinct from the originating company's operations.[23] The true sale of assets coupled with the limited function of the SPE for non-consolidation structuring will typically suffice to ensure the bankruptcy-remote[24] status of the SPE.[25] This bankruptcy-remote entity can either issue securities itself, or it can transfer the assets to a trust or another entity that in turn issues securities to investors backed by a security interest in these assets.[26] Third party investors purchase these securities in reliance on the bankruptcy-remoteness of the transaction and, typically, an investment grade credit rating by an independent rating agency.[27] The proceeds received from the sale of securities to investors serve as the funding for the purchase of assets from the originating company.[28] After the sale of the securities, the originating company or a third party services the assets, collects the payments on the assets, and remits the proceeds to a trustee for distribution to the investors to repay the interest and amortized principal of the securities.[29]

### *B. Ongoing Transferor Involvement and the Two-Tier Structure*

Assets typically used in a securitization, such as mortgage or credit card obligations or accounts receivable, often remain subject to dilution,[30] partial or non-payment, and other defects; therefore, many asset securitization transactions typically require liquidity support and credit enhancements as part of the transaction structure to provide additional assurance to investors that sufficient assets exist to repay obligations.[31] At a minimum, the originating company will provide certain warranties and representations of the quality of the assets.[32] In addition, typically the SPE will often purchase from the originator collateral in excess of the principal balance of the securities issued; the value of such excess is called overcollateralization.[33] Depending on the structure of the transaction, this overcollateralization may be represented by a residual interest security.[34] Overcollateralization provides additional security for the repayment of the securities.[35] The originating company might also agree to repurchase a limited amount of defaulted or

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concept. This Note, therefore, uses the terms interchangeably.

23. *See infra* Part II.B.

24. Asset-backed securitization uses the term "bankruptcy-remote" as opposed to "bankruptcy-proof" because "bankruptcy courts, as courts of equity, will use their equity jurisdiction to avoid what they deem to be an inequitable result, even if that means collapsing an Asset Backed Securitization ("ABS") structure in contravention of basic tenets of state contract law." Stark, *supra* note 21, at 228 (footnotes omitted).

25. *See id.* at 215.

26. *Id.* at 214.

27. *Id.*

28. *Id.* at 215.

29. *Id.* See Appendix A of this Note for an illustration of the basic transaction.

30. "Dilution" includes credits, returns, or bad debts that might occur with certain accounts receivable. *See* Lunelle Siegel, Business Owner's Guide to Asset Based Lending, *at* http://www.businesscash.com/articles/ABLArticle.PDF (last visited Apr. 15, 2004).

31. *See* Len Blum & Chris DiAngelo, *Structuring Efficient Asset-Backed Transactions*, *in* ISSUER PERSPECTIVES ON SECURITIZATION 17, 30–34 (Frank Fabozzi ed., 1998).

32. *See* Thomas E. Plank, *The True Sale of Loans and the Role of Recourse*, 14 GEO. MASON L. REV. 287, 306 (1991).

33. *See* Roever, *supra* note 16, at 8 (describing overcollateralization as the "use of a larger pool of assets to support a smaller amount of securities. For example, $100 million in debt might be supported by $110 million in collateral.").

34. *See* Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133, 142 (1994) (discussing the various forms that overcollateralization can take).

35. *See* Blum & DiAngelo, *supra* note 31, at 30–31.

delinquent receivables or loans from the SPE if necessary (often referred to as a removal of accounts provision or "ROAP"), or the issuer might be allowed to pay the trustee to have such receivables released from the trustee's lien.[36] A transferor or the issuer might also provide derivative support for the securities in the form of an interest rate hedge to address the differences between the interest paid to the investors and the interest received on the assets.[37] Finally, many transactions can involve third-party support and credit enhancement, usually in the form of an insurance policy or a letter of credit from a financial institution that backs some or all of the securities issued in the transaction (e.g., total value of the asset pool or securities issue, or possibly a governmental guarantee on mortgage loans).[38] All of these credit enhancements support the overall structure and improve an independent credit rating agency's rating of the asset-backed security pool.[39] Often the more assurances as to the quality of the assets and guarantees, the higher the credit rating, resulting in a lower interest cost to the originating company.[40] The more guarantees and assurances from the operating company, however, the more complicated this structure becomes from both a legal and accounting perspective. Moreover, if the proper bankruptcy structuring is not achieved, then the rating agencies will not be able to give their ratings.[41]

The transferor's continuing involvement in servicing the assets, providing recourse guarantees, and other types of liquidity support—such as holding a subordinated residual interest in the transferred assets—can often complicate these transactions, especially for assuring the legal isolation and true sale of assets. Because this interrelatedness resembles a form of control and continuing involvement by the transferor, many asset securitizations involve a two-tier structure with, in essence, two "sales" or transfers of the assets as opposed to one to ensure isolation from bankruptcy.[42] As a first step, the originating company typically sells the underlying assets:

> [T]o a special-purpose corporation that, although wholly owned, is so designed that the possibility that the transferor or its creditors could reclaim the assets is remote. This first transfer is designed to be judged to be a true sale at law, in part because the transferor does not provide "excessive" credit yield or protection to the special-purpose corporation, and [the FASB] understands that transferred assets are likely to be judged beyond the reach of the transferor or the transferor's creditors even in bankruptcy.[43]

Sometimes, this first SPE will be the issuer of the asset-backed securities. However, whether because of the accounting rules or other structuring issues, the first SPE may transfer assets to a second SPE that will be the issuer of the asset-backed securities.

36. *See* Andrew A. Silver, *Rating Structured Securities, in* ISSUER PERSPECTIVES ON SECURITIZATION 67, 82 (Frank Fabozzi ed., 1998).

37. *Id.* at 80.

38. *Id.* at 86–88.

39. *See generally id.* at 67–91 (discussing credit rating process).

40. *See* Roever, *supra* note 16, at 8–9.

41. *See* Silver, *supra* note 36, at 83–89 (discussing the legal and regulatory considerations that play into the credit rating decision by an independent credit rating agency).

42. *See* SFAS 140, *supra* note 11, at § 83; *see also* Marty Rosenblatt & Jim Johnson, *Securitization Accounting Under FAS 140 - The Standard Formerly Known as FASB* 125, 829 PLI/COMM 793, 821 (2001); Roever, *supra* note 16, at 6–7. *See* Appendix B of this Note for an illustration of the two-tier structure.

43. *See* SFAS 140, *supra* note 11, at § 83(a).

The two step transactions utilized in many asset securitization transactions often provide additional protection of the assets against the bankruptcy of the originator. In the two-step transactions:

> [T]he special-purpose corporation transfers the assets to a trust or other legal vehicle with a sufficient increase in the credit or yield protection on the second transfer (provided by a junior retained beneficial interest or other means) to merit the high credit rating sought by third-party investors who buy senior beneficial interests in the trust. Because of that aspect of its design, that second transfer might not be judged to be a true sale at law and, thus, the transferred assets could at least in theory be reached by a bankruptcy trustee for the special-purpose corporation.[44]

In this structure, the intermediate SPE eliminates the interrelatedness between the originating company and the issuer-SPE that holds the transferred assets.[45] In addition, although the seller's residual interests or guarantees in the second step might resemble a secured loan at law rather than a "true sale" of assets, the isolation of assets from the bankruptcy of the originating company would still exist because

> [T]he special-purpose corporation is designed to make remote the possibility that it would enter bankruptcy, either by itself of by substantive consolidation into a bankruptcy of its parent should that occur. For example, its charter forbids it from undertaking any other business or incurring any liabilities, so that there can be no creditors to petition to place it in bankruptcy. Furthermore, its dedication to a single purpose is intended to make it extremely unlikely, even if it somehow entered bankruptcy, that a receiver under the U.S. Bankruptcy Code could reclaim the transferred assets because it has no other assets to substitute for the transferred assets.[46]

To appreciate why asset securitization structures take this form, an understanding of the principles of true sale and consolidation at law and for accounting is critical. Moreover, potential changes in either the legal or accounting characterizations of this transaction could significantly affect the structures in the future.

## III. LEGAL ASPECTS: TRUE SALE AND CONSOLIDATION

A bankruptcy court might scrutinize a securitization transaction on two separate grounds, namely whether the transaction constitutes a "true sale" at law and whether the court should impose a substantive consolidation of the assets and liabilities based on the entities' interrelated character, activities, and functions. A legal analysis of the overall transaction will dictate the appropriate accounting treatment for the securitization as well.

44. *Id.* § 83(b).

45. A SPE can issue a blanket beneficial interest to a conduit that a bank or financial institution has created. The conduit in turn issues commercial paper. Alternatively, the conduit might just issue beneficial interests to several investors themselves. *See generally* Roever, *supra* note 16, at 10–14.

46. SFAS 140, *supra* note 11, § 83(c).

### A. True Sale at Law

One important aspect of the asset securitization process rests upon the actual sale of the assets such that they no longer belong to the originating company and title to the assets has passed for the benefit of the investors.[47] If a court determines that the transaction resembles more of a secured loan than a "true sale," the originator would still have an equitable interest in the assets, and this property interest would become a part of the bankruptcy estate subject to the automatic stay provision of the Bankruptcy Code.[48] Under the automatic stay in bankruptcy, the filing of the bankruptcy petition operates as a suspension of any activities by secured creditors and unsecured creditors regarding their interests in the property of the estate.[49] Although a secured creditor does not lose its security interest by virtue of the bankruptcy, the automatic stay does delay the process in realizing that security interest while the trustee evaluates and pays all of the claims against the estate.[50] Thus, in such circumstances, a true sale becomes critical because an automatic stay would delay the payment of principal and interest to the investors and may reduce the amount of collateral available to make such payments.[51]

Some commentators have defined a "true sale" for asset securitizations as "a transfer of financial assets in which the parties state that they intend a sale, and in which all of the benefits and risks commonly associated with ownership are transferred for fair value in an arm's length transaction."[52] Moreover, to determine if a transaction qualifies as a "true sale," courts will examine a number of factors including:

> 1. Did the parties intend for the transaction to be a sale or to create only a security interest in favor of the transferor?
> 2. Regardless of intent, have the risks and benefits of ownership truly been transferred? Does the transferor or the transferee bear the risk of loss to the asset being transferred? The greater the recourse to the transferor, the more likely the transfer will not be upheld as a true sale.
> 3. Did the transferee acquire an interest in identifiable assets?[53]

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47. *See* Stark, *supra* note 21, at 217.

48. *See* Peter J. Lahny IV, *Asset Securitization: A Discussion of the Traditional Bankruptcy Attacks and an Analysis of the Next Potential Attack*, Substantive Consolidation, 9 AM. BANKR. INST. L. REV. 815, 844 (2001) (referring to 11 U.S.C. § 541(a)(1), which provides that the bankruptcy estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case").

49. 11 U.S.C. § 362(a) (2000).

50. *See* Lahny, *supra* note 48, at 818 (discussing the trustee's ability to use the collateral of the investors during bankruptcy and its ability to evaluate executory contracts).

51. *Id.*

52. Peter v. Pantaleo et. al., *Rethinking the Role of Recourse in the Sale of Financial Assets*, 52 BUS. LAW. 159, 159 (1996).

53. *See* Lahny, *supra* note 48, at 843 (citing RONALD S. BOROD, SECURITIZATION, ASSET-BACKED AND MORTGAGE BACKED SECURITIES 7-24 (3d. ed. 1991)). *See also* Stark, *supra* note 21, at 218 (listing risk of loss, structure, and intent as factors that courts look at in conducting a true sale analysis); Robert D. Aicher & William J. Fellerhoff, *Characterization of a Transfer of Receivables as a Sale or a Secured Loan Upon Bankruptcy of the Transferor*, 65 AM. BANKR. L.J. 181, 186–98 (1991) (discussing the factors and cases evaluating the true sale versus loan determination); Lois R. Lupica, *Circumvention of the Bankruptcy Process: The Statutory Institutionalization of Securitization*, 33 CONN. L. REV. 199, 213 (2000) (stating that "the determination of whether an asset transfer is a 'true sale' or a secured loan is not governed by a statutory rule; rather, it is an equitable determination made by the courts based upon the presence (or absence) of a variety of factors"). Although there is no case law directly on point discussing these factors with respect to asset securitizations specifically, cases evaluating other contractual arrangements do lend illustrative guidance of these factors. *See, e.g.*, *In re* Lemmons & Assocs., 67 B.R. 198, 209–10 (Bankr. D. Nev. 1986) (stating that buyer's objective indications of an intended sale were sufficient in deeming the transaction to be a sale and not a loan); Major's Furniture Mart v. Castle Credit Corp., 602 F.2d 538, 544 (3d Cir. 1979) (stating that the presence of resource in an agreement does not automatically convert a sale into a security interest); Fireman's Fund Ins.

Therefore, the legal analysis essentially requires an evaluation of which parties bear the benefits and burdens (or risks and rewards) of ownership of the assets. Benefits and burdens associated with assets in a securitization can include the right to future market value of the asset, the risk of loss, and the burden of servicing the assets.[54] It would appear from these factors that the presence of recourse[55] to or other involvement from the originator would qualify as the critical factor; however, courts have reached different conclusions as to whether recourse to the seller automatically qualifies a transaction as a secured loan as opposed to a true sale.[56] To avoid this uncertainty, the two-tiered structure common to many asset securitizations permits at least one true sale of assets at law whereby the originator has no continuing involvement in the assets and instead the wholly-owned subsidiary purchaser of the assets provides the necessary assurances to investors in the second transfer of the assets. By placing the assets two entities away from the initial transferor, the two-step structure can provide the requisite isolation for legal purposes.

### *B. Substantive Consolidation*

Even if a bankruptcy court determines that the company has met the true sale requirement for the transaction, creditors of the debtor/transferor still might challenge the structure by imposing a substantive consolidation. Substantive consolidation, similar to a piercing the corporate veil theory, represents an equitable remedy imposed by bankruptcy courts in which the court will refuse to recognize the separate legal identities of two entities and will effectively consolidate the assets and liabilities of the involved companies.[57] Therefore, limited functionality of the SPE serves an important role in ensuring separation from the originator, including its ability to incur obligations other than those evidenced by the securities or for the SPE's board of directors to vote in favor of a voluntary filing.[58] As such, the articles of incorporation of an SPE in a securitization transaction usually contain the following provisions:

- [T]he SPV may not incur indebtedness other than that which is evidenced by the securities or incurred in the ordinary course of business related to the ownership and management of the collateral;
- [T]he SPV is prohibited from dissolving, liquidating, consolidating, merging or selling assets for as long as the securities remain outstanding;
- [T]he SPV's ability to transact with affiliates (including the originator) must be according to the arm's-length and commercially reasonable terms;
- [T]he SPV's board must include one "independent" director, which is a person unaffiliated with the SPV or the originator;
- [T]he unanimous consent of the SPV's board of directors (including the consent of the independent director) is necessary for the SVP to file for bankruptcy, receivership or take any other "Bankruptcy Action";

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Cos. v. Grover (*In re* Woodson) 813 F.2d 266, 272 (9th Cir. 1987) ("Simply calling transactions 'sales' does not make them so.").

54. *See* Plank, *supra* note 32, at 338.

55. Indirect or direct recourse to the seller can include "warranties as to collectibility; holdbacks from the purchase price; adjustments to the purchase price; guarantees by the originator; keep-well arrangements by the originator; collateral security from the originator; obligations to repurchase, or substitute for, underperforming receivables; and, retention by the originator of subordinated interests." Stark, *supra* note 21, at 218 (footnotes and citations omitted).

56. *See* Plank, *supra* note 32, at 290–91.

57. *See* Lahny, *supra* note 48, at 822.

58. *See* Stark, *supra* note 21, at 215.

- [T]he SPV is obligated to maintain a separate corporate existence from any other entity (especially the originator) by, among other things, maintaining separate books and records, accounts, and employees and observing all corporate formalities; and
- [A]fter the issuance of the securities, the SPV may not amend its articles of incorporation respecting any of the above without first obtaining (a) approval of the investors and (b) confirmation from the rating agencies that such amendment would not result in a qualification, withdrawal, or downgrade of the rating of the securities.[59]

Although these structural features do provide additional assurance against a substantive consolidation, there is never one hundred percent certainty a court will uphold these formalities.

Even by following the formality of keeping the affairs separate at formation, ultimately the court's judgment will dictate whether it believes that the entities acted separately and isolated enough to not require a consolidation of the entities. In making this determination the courts will typically apply a standard initially established by the D.C. Court of Appeals in *In re Auto-Train.*[60] In *Auto-Train*, the court applied the following two-part balancing test to determine when a substantive consolidation is appropriate: (1) whether there is "a substantial identity between the entities to be consolidated"; and (2) whether "[substantive] consolidation is necessary to avoid some harm or to realize some benefit."[61] The first prong of this test requires an inquiry into a group of factors, of which none are dispositive:

1. The degree of difficulty in segregating or ascertaining individual assets and liabilities;
2. The presence or absence of consolidated financial statements;
3. The profitability of consolidation at a single physical location;
4. The commingling of assets and business functions;
5. The unity of interests and ownership between the various corporate entities;
6. The existence of parent and intercorporate guarantees on loans; and
7. The transfer of assets without observance of corporate formalities.[62]

Ongoing involvement by the originator can play a role in a court deciding to impose a consolidation, such as the presence of intercorporate guarantees (e.g. a recourse obligation, or residual interest) or whether the originator exhibits any control over the assets.

The second prong of the *Auto-Train* test—requiring substantive consolidation to avoid some harm or realize a benefit—often becomes an equitable determination by the court.[63] A creditor can sometimes defeat substantive consolidation by demonstrating that it relied solely on the credit of one of the entities involved.[64] As a result, a bankruptcy court often must evaluate whose interests are more important: the investors in an asset securitization or the unsecured creditors and other constituents to a bankrupt originator. Ultimately, as with the true sale analysis at law, no clear answer exists as to whether a court will impose a substantive consolidation. Thus, attorneys structuring these transactions attempt to provide as much separateness between the entities as possible. Once again, the two-tier structure becomes useful in this regard for assuring isolation of interests.

59. *Id.* at 216 (footnote omitted).
60. *In re* Auto-Train Corp., Inc., 810 F.2d 270, 276 (D.C. Cir. 1987) (citations omitted).
61. *See* Lahny, *supra* note 48, at 867 (footnotes and citations omitted).
62. *Id.* at 868 (citing *In re* Vecco Constr. Indus., Inc., 4 B.R. 407, 410 (Bankr. E.D. Va. 1980)).
63. *Id.*
64. *Id.*

## IV. ACCOUNTING TREATMENT OF ASSET SECURITIZATION

Financial accounting, the means that managers of businesses use to report to owners as to the performance of the business in financial terms,[65] does not represent the law, but it does impact decisions as to how to structure legal transactions. The field of accounting represents an area largely subject to private regulation.[66] Although Congress has delegated to the Securities and Exchange Commission (SEC) the legal authority to establish accounting principles for publicly-traded companies or other enterprises subject to its jurisdiction, the SEC has primarily deferred regulation to the private sector's official standard setter, currently the FASB.[67] With the recent accounting scandals associated with Enron, WorldCom, and HealthSouth, however, Congress and the SEC have become more involved in regulating accounting. For instance, legislation such as the Sarbanes-Oxley Act[68] mandated a study by the SEC of the current state of the accounting principles as well as the need for other disclosure requirements in financial reporting.[69] Given the inconsistent principles and convoluted framework set forth by the FASB and prior private standard setters, however, the possibility of further government intervention becomes more likely.[70] Therefore, it is important to understand the various Generally Accepted Accounting Principles (GAAP) that presently exist to appreciate the inner tension within GAAP and gain a sense of what requires change and might potentially affect the treatment of asset securitization structures.

The rule governing the accounting treatment for asset securitization, SFAS 140, represents an attempt to synthesize some conflicting accounting concepts into one comprehensive statement relating to transfers of financial assets. SFAS 140, however, does reflect a shift from some of the traditional broad-based accounting principles. SFAS 140 has provided a set of arguably "bright-line" rules for a true sale and non-consolidation in an asset securitization. These bright-line rules have received criticism for encouraging companies like Enron to use the SPE structure to achieve off-balance sheet transfers of assets and realize the associated revenue from the transfer as permitted under SFAS 140.[71] On the other hand, Enron hid the fact that it ultimately guaranteed the "at-risk" equity invested in these SPEs from its auditors, which would require disclosure under accounting for liabilities.[72] Not only have these bright-line rules permitted abuse by companies such as Enron, but SFAS 140's divergence from some of the gener-

65. George Mundstock, *The Trouble with FASB*, 28 N.C. J. INT'L L. & COM. REG. 813, 814–815 (2003).

66. *See id.*

67. *See supra* note 8 and accompanying text.

68. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 §108, 116 Stat. 745 (codified in scattered sections of 15, 18, 28 and 29 U.S.C.A. (West Supp. 2002)).

69. The Sarbanes-Oxley Act states that "[The SEC] shall conduct a study on the adoption by the United States financial reporting system of a principles-based accounting system." *Id.* §108(d)(1)(A). In addition, the legislation mandates that the SEC conduct a study within a year to determine: "(A) the extent of off-balance sheet transactions, including assets, liabilities, leases, losses, and the use of special purpose entities; and (B) whether generally accepted accounting rules result in financial statements of issuers reflecting the economics of such off-balance sheet transactions to investors in a transparent fashion." *Id.* §401(c)(1).

70. *See* Mundstock, *supra* note 65, at 838.

71. *See* Final Report of Neal Batson, Court-Appointed Examiner, dated Nov. 4, 2003, at Appendix B 86–94, *In re* Enron Corp., Chapter 11 Case, No. 01-16034 (AJG), *available at* http://www.enron.com/corp/por/examinerfinal.html (last visited Apr. 15, 2004) [hereinafter Batson Report] (discussing the fact that Enron should have disclosed the total return swap in these transactions, the nature of recourse and continuing involvement in the securitizations, and that many of these transactions violated the legal isolation requirement for a true sale under SFAS 140).

72. *Id.*

ally-accepted accounting principles has also generated criticism and response from FASB, the International Accounting Standards Board (IASB),[73] and the SEC, such that the requirements as they currently exist will likely change going forward.[74]

To appreciate what might likely change with regard to the current standard, one first should understand the potentially conflicting broad-based accounting concepts that provide the most difficulty for SFAS 140. The conflicts inherent in SFAS 140 derive from overarching concepts relating to revenue recognition, asset and liability measurement, and consolidation—many of which have projects underway to completely overhaul the standards and potentially converge with the International Accounting Standards (IAS) in an effort to provide a more unified approach to the accounting treatment for such transactions across the globe.[75] In addition, because SFAS 140 has received criticism for resembling more of a "rules-based" approach that contravenes the "principles-oriented" approach increasingly advocated by the governing accounting authorities,[76] the accounting standard becomes especially vulnerable to change.

### *A. True Sale Definition Under SFAS 140 and Principles of Revenue Recognition*

Revenue recognition—the means by which a company measures income—represents one of the cornerstone concepts of accounting. Unfortunately, no one overarching principle currently exists. The standards for revenue recognition embodied within GAAP consist of broad-based conceptual discussions coupled with industry-specific guidance.[77] FASB and the IASB have teamed up in a revenue recognition project to provide one broad-based statement regarding revenue recognition; however, the actual release of a final statement will likely not occur until 2005 at the earliest.[78] As a

73. The IASB represents the successor organization to the International Accounting Standards Committee (IASC). The IASC consisted of members of various countries and sought to provide international accounting standards for foreign companies. The IASB, formed in 2001, has become the focus for convergence in international accounting principles. *See* Mundstock, *supra* note 65, at 841–844.

74. FASB has already responded by issuing an interpretation to Accounting Research Bulletin 51 ("ARB 51") with an interpretation to address consolidation in light of risks and rewards derived by related parties. *See generally* CONSOLIDATION OF VARIABLE INTEREST ENTITIES: AN INTERPRETATION OF ARB NO. 51, Financial Accounting Standards Board Interpretation No. 46 (Financial Accounting Standards Bd. 2003) [hereinafter FIN 46]. FIN 46 does not apply to traditional basic asset securitizations because of the common use of a qualified special purpose entity (QSPE) as opposed to just a special purpose entity. *See infra* Part IV.C. FIN 46 defers to SFAS 140 for consolidation treatment of structures using a QSPE. *Id.* In addition, the FASB has released an Exposure Draft for proposed amendments to SFAS 140 that will likely result in changes to the rules described herein. *See* QUALIFYING SPECIAL-PURPOSE ENTITIES AND ISOLATION OF TRANSFERRED ASSETS—AN AMENDMENT OF FASB STATEMENT NO. 140, Proposed Statement of Financial Accounting Standards, ¶ A11 (Financial Accounting Standards Bd., 2003), *available at* http://www.fasb.org/ draft/ ed_qspe.pdf (last visited March 24, 2004) [hereinafter Exposure Draft].

75. *See* Short-term International Convergence, FASB Project Update, *at* *http://www.fasb.org/project/short-term_intl_convergence.shtml* (last visited Apr. 15, 2004) [hereinafter International Convergence Project]; *see also* Short-term Convergence Project Scope, Sequencing, and Items to be Included in the First Exposure Draft, FASB Board Meeting Minutes at 2 (Nov. 13, 2002), *at* http://www.fasb.org/board_meeting_minutes/10-2-02_convergence.pdf (last visited Apr. 15, 2004) (discussing the seventeen issues to be included in the project including financial instruments, disclosure, presentation, recognition, and measurement); Revenue Recognition, FASB Project Update, *at* http://www.fasb.org/project/revenue_recognition.shtml (last visited Apr. 15, 2004) [hereinafter Revenue Recognition Project] ("The Board is partnering with the International Accounting Standards Board (IASB) on this project. . . . The planned comprehensive revenue recognition Statement will . . . eliminate the inconsistencies in the existing authoritative literature and accepted practices . . . .").

76. *See supra* note 15 and accompanying text.

77. Staff Accounting Bulletin No. 101, 64 Fed. Reg. 68936 (1999) [hereinafter SAB 101].

78. *See* Revenue Recognition Project, *supra* note 75. The project goal seeks to "develop a comprehensive

result, one must become acquainted with the various relevant pronouncements in the area as they currently exist in order to appreciate how SFAS 140 incorporates these varying concepts and how the rule diverges.

1. Basic Fundamentals of Revenue Recognition

In light of the various definitions and guidance regarding revenue recognition, the SEC attempted to provide a more consistent approach in its Staff Accounting Bulletin No. 101 (SAB 101).[79] SAB 101 states that to the extent that a transaction falls within the scope of specific accounting literature, that statement will govern; otherwise, the existing authoritative accounting standards and broad-based revenue recognition criteria apply.[80] Although SAB 101 arguably only applies to SEC registrants by virtue of the source of the authority (e.g. the staff of the SEC), SAB 101 does offer a persuasive argument for why SFAS 140 provisions for the accounting definition of a true sale and corresponding recognition of revenue or gains should apply, as opposed to the broad-based revenue recognition principles (absent an overarching statement by FASB changing the current framework).[81]

In addition to the specific provisions of SFAS 140, however, it is also important to examine the various conceptual statements of revenue recognition that currently exist to explain why the provisions of SFAS 140 contradict some of these principles and where potential vulnerability to change exists. In essence, two competing broad-based conceptual frameworks potentially apply for the definition of revenue recognition. Under the concept statements promulgated by FASB, FASB Concept Statement No. 5 (SFAC 5) provides that an entity cannot recognize revenue or a gain for the sale of assets until *realized* or *realizable* (e.g., when exchanged for cash or readily convertible to cash) and until *earned* (e.g., when the entity has substantially performed and possesses an entitlement to the benefits).[82] On the other hand, FASB Concept Statement No. 6 (SFAC 6) defines revenue in terms of differences between assets and liabilities: "revenues are inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute an entity's ongoing major or central operations."[83] In addition, a gain under SFAC 6 represents "increases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from revenues or investments by

statement on revenue recognition that is conceptually based and framed in terms of principles." *Id.* However, the planned release of an Exposure Draft for proposed changes is not until the 3rd quarter of 2004, with no planned release date yet for the final draft. *Id.*

79. *Id.*

80. *Id.*

81. Note that the FASB and IASB have commenced work on a complete overhaul of the principles of revenue recognition which will likely change the current accounting literature. *See* International Convergence Project, *supra* note 75.

82. *See* RECOGNITION AND MEASUREMENT IN FINANCIAL STATEMENTS OF BUSINESS ENTERPRISES, Statement of Financial Accounting Concepts No. 5, § 83 (Financial Accounting Standards Bd. 1984) [hereinafter SFAC 5].

83. ELEMENTS OF FINANCIAL STATEMENTS, Statement of Financial Accounting Concepts No. 6, § 78 (Financial Accounting Standards Bd. 1985) [hereinafter SFAC 6].

owners."[84] Thus, potential differences in revenue recognized might emerge depending on the approach used.

Although the FASB concept statements only have persuasive authority as accounting literature in the GAAP hierarchy[85] and offer only a general framework, they often provide important insights into understanding the differing viewpoints and their related impact on industry-specific rules and potentially the objectives-based principles that might result from the FASB Revenue Recognition project. The Revenue Recognition Project's initial conclusions indicate a preference for an approach consistent with SFAC 6, in terms of changes between fair values of assets and liabilities and the related impact on equity as opposed to a realization and earnings approach to revenue.[86]

Notwithstanding the ongoing Revenue Recognition Project, the closest thing to a comprehensive statement or principle of revenue recognition rests in SAB 101, which attempts to summarize the various principles and concepts embodied in the accounting literature. SAB 101 bases its definition upon the realized or realizable and earned components of revenue proposed by SFAC 5, along with four other criteria.[87] These four requirements are: (1) persuasive evidence of a sales arrangement; (2) delivery or rendering of services (*e.g.* substantial performance by the seller); (3) a fixed or determinable price by the seller to the buyer;[88] and (4) a reasonable basis for the seller to conclude that the buyer will have the ability to pay the purchase price.[89] SAB 101 advocates recognition of revenue only when a transfer of risk and rewards has occurred, along the same lines of SFAC 5.

Finally, because of the presence of ROAPs and other retained residual interests to offset delinquent assets in asset securitizations, it becomes important to understand FASB's position with regard to the role of a right of return (a form of risk), and its requisite impact on revenue recognition under general accounting principles as mandated by Statement of Financial Accounting Standards No. 48 (SFAS 48).[90] SFAS 48 governs rights of return in the context of goods; its requirements, however, prove useful by analogy. For instance, SFAS 48 imposes six requirements, including the existence of economic substance of the buyer apart from that provided by the seller, the lack of significant obligations of the seller to bring about resale by the buyer, and the ability to reasonably estimate the amount of future returns before a seller can recognize revenue when the buyer enjoys the right to return the product.[91] The other requirements for revenue recognition include a substantially fixed or determinable price of the buyer to the seller, the actual payment by the buyer to the seller, and the bearing of risk of theft or damage to the product by the buyer.[92] In addition, SFAS 48 also lists five factors that

84. *Id.* § 82.

85. HERWITZ & BARRETT, *supra* note 8, at 169–70.

86. *See* Revenue Recognition Project, *supra* note 78.

87. *See* SAB 101, *supra* note 77.

88. This would not exist if the buyer has the unilateral right to cancel or terminate the sale. However, a right of return does not preclude revenue recognition, rather, Statement of Financial Standards No. 48 ("SFAS 48") provides specific guidance on revenue recognition when a right of return exists. *See* David B. Harms et al., *Behind the Numbers: A Review of Six Accounting Problem Areas in the* News, 1342 PLI/CORP 579, 586 (2002).

89. *See* SAB 101, *supra* note 77; *see also* Harms et al., *supra* note 88, at 586.

90. REVENUE RECOGNITION WHEN RIGHT OF RETURN EXISTS, Statement of Financial Accounting Standards No. 48 (Financial Accounting Standards Bd. 1981) [hereinafter SFAS 48].

91. *Id.* § 6.

92. *Id.*

might impair the seller's ability to make a reasonable estimate as to returns, and thus should preclude revenue recognition. These factors include: technological obsolescence of the product, a long return period, absence of historical experience with similar types of sales and types of sales, absence of a large volume of homogenous transactions, and significant increases in inventory levels.[93] To the extent that securitizations involve the return of assets and absorption of some of the losses, SFAS 48 would suggest precluding revenue recognition on those assets until the end of the securitization or such time that the assets became identifiable.

2. How SFAS 140 Diverges: Current Accounting Rules for a "True Sale"

Because revenue recognition and the overall state of accounting principles prove inconsistent and highly specialized, FASB has developed a separate standard of accounting for asset securitization that selects features from the underlying concepts. FASB justifies a separate set of rules for these transactions based upon the fact that asset securitization involves financial assets that have their own unique features requiring special consideration.

*a. Background*

The accounting treatment for asset-backed securitization under SFAS 140 differs from the traditional risk and rewards framework that the accounting standards and legal analysis advocates. In developing this accounting standard, FASB first acknowledged that the IASB and the United Kingdom Accounting Standards Board operate under the risks and rewards concept for treatment of asset securitizations, which requires a surrender of "substantially all" of the risks and rewards to the buyer to no longer recognize ("derecognize") an asset.[94] FASB determined, however, that too many difficulties arise with the "substantially all" of the risks approach because of the difficulties inherent in identifying, weighing, measuring, and balancing those risks and rewards.[95] In addition, FASB argues that this risks and rewards approach does not comport with the recent developments in the financial markets, the accounting for transfers and servicing of financial assets, and extinguishment of liabilities.[96]

FASB responded with a "financial-components approach" that built upon the SFAC 6 conceptual approach of differences in assets and liabilities as opposed to risk and rewards.[97] According to SFAS 140, the financial components approach "analyzes a transfer of a financial asset by examining the component assets (controlled economic benefits) and liabilities (present obligations for probable future sacrifices of economic benefits) that exist after the transfer."[98] As a result of the transfer, new assets and liabilities emerge for both parties and each party derecognizes the assets and liabilities extinguished in the transfer.[99] This treatment derives from SFAC 6's definition of assets and

93. *Id.* §§ 6, 8.
94. SFAS 140, *supra* note 11, at §§ 132–135.
95. *Id.* §§ 134, 140.
96. *Id.* § 141.
97. *Id.* § 140.
98. *Id.* § 142.
99. *Id*; *see also infra* Part IV.B.

liabilities in terms of the obtaining or sacrificing of future economic benefits.[100] Moreover, SFAS 140 builds upon the notion that these economic benefits can "unbundle" into new assets and liabilities since SFAC 6 states that no entity can own the same asset.[101]

Finally, the FASB argues that application of this concept of unbundled assets and liabilities should only apply here because it deals with financial instruments[102] that have unique characteristics. The FASB supports this proposition by its recognition that the economic benefits of financial instruments derive from the contractual provisions underlying the assets, such as the right to future cash flows.[103] The key distinction under SFAS 140 therefore becomes what entity has effective *control* (as opposed to risk) over these benefits.[104] In addition, SFAS 140 argues that the entities with the primary liability and the entities with the liability of a guarantee should recognize these liabilities accordingly.[105] The Board argues that "transferors and transferees should account symmetrically for transfers of financial assets."[106] Furthermore, according to FASB, the transferor's activities associated with generating an asset should not affect the recognition of financial assets or liabilities unless the transferor maintains effective control over the transferred assets.[107] Therefore, the extent of permitted involvement by the transferor and definition of effective control becomes critical. SFAS 140 addresses the elements used to determine effective control in its three-part definition of a true sale.[108]

*b. Three-Part Standard for a True Sale Under SFAS 140*

In building upon the SFAC 6 conceptual approach, SFAS 140 established a three-part rule in determining whether a transferor has surrendered control. The definition requires (1) the isolation of the transferred assets "presumptively beyond" the reach of the transferor; (2) the grant to the transferee of the right to pledge or exchange either the transferred assets or beneficial interests in the transferred assets, with no condition that both constrains the transferee from utilizing its right to pledge or exchange the assets or that provides more than a trivial benefit to the transferor; and (3) the assurance that the transferor "does not maintain effective control over the transferred assets through an agreement to repurchase or redeem them before their maturity or through the ability to unilaterally cause the holder to return specific assets."[109] Essentially, the definition not

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100. *See* SFAC 6, *supra* note 83, at §§ 25, 35 (footnotes omitted).

101. *Id.* § 183 ("[E]very asset is an asset of some entity; moreover, no asset can simultaneously be an asset of more than one entity.").

102. The definition for a "financial instrument" under SFAS 140 uses that of SFAS 107:

> cash, evidence of an ownership interest in an entity, or a contract that both a) imposes on one entity a contractual obligation to (1) to deliver cash or another financial instrument to a second entity or (2) to exchange other financial instruments on potentially unfavorable terms with the second entity [and] b) conveys to that second entity a contractual right (1) to receive cash or another financial instrument form the first entity or (2) to exchange other financial instruments on potentially favorable terms with the first entity.

DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS, Statement of Financial Accounting Standards No. 107, § 3 (Financial Accounting Standards Bd. 1991) (footnotes omitted).

103. *See* SFAS 140, *supra* note 11, § 146.

104. *Id.*

105. *Id.*

106. *Id.*

107. *Id.*

108. *Id.* § 9.

109. SFAS 140, *supra* note 11, § 151.

only requires a legal type of determination as to the isolation of the assets, but it also looks to any benefits derived by the transferor and the control exerted over the assets.

The first part of the three-part definition of a true sale for accounting in effect requires a legal assessment regarding the isolation of the assets from the bankruptcy of the originator. The legal isolation assessment typically requires an auditor to look at the facts and circumstances of the particular transaction. This assessment often includes "making judgments about the kind of bankruptcy or other receivership into which a transferor or SPE might be placed, whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee, and other factors pertinent under applicable law."[110] An accountant often supports the assessment of legal isolation in non-third party transactions via true sale and non-consolidation opinion letters written by attorneys documenting the securitization.[111] Because courts have not ruled definitively as to what constitutes isolation, however, these opinion letters can often prove heavily qualified as to the overall legal assessment.[112] Nevertheless, the letter satisfies the first requirement in the definition of a true sale for accounting purposes.[113]

The second and third requirements of the accounting definition of a true sale under SFAS 140 focus on the ongoing rights and benefits of the transferor and the transferee with respect to the assets. For instance, in the second part of the true sale definition, a sale of assets has occurred if the transferee retains the right to pledge or exchange the assets (or beneficial interests).[114] The requirement arises from the concept in SFAC 6 that establishes that a transfer of assets occurs upon a transfer of primary economic benefits.[115] Because the main benefit of the transferred asset consists mostly of the contractual right to future cash flows, FASB determined that the ability to exchange or pledge the asset as collateral would allow the transferee to obtain all or most of the cash inflows (economic benefits) from the assets.[116] FASB also requires that no condition constrain the transferee's right to pledge or exchange the assets and represent a trivial benefit to the transferor.[117] For example, if the transferor imposed a condition in a transfer contract that prohibited the selling or pledging of a transferred loan receivable, it would not only constrain the transferee but also provide the transferor with more than a trivial benefit in knowing who has the asset and potentially blocking it from resale to a competitor.[118] In addition, provisions that permit the repurchase of assets or call provisions permitting purchase of assets at a later date can not only represent more than a constraint or trivial benefit to the transferor, but can also raise issues of effective control requirement in the third part of the true sale definition.

110. *Id.* § 27.

111. *See* Blum & DiAngelo, *supra* note 31, at 23.

112. *See* Rosenblatt & Johnson, *supra* note 42, at 821.

113. THE USE OF LEGAL INTERPRETATIONS AS EVIDENTIAL MATTER TO SUPPORT MANAGEMENT'S ASSERTION THAT A TRANSFER OF FINANCIAL ASSETS HAS MET THE ISOLATION CRITERION IN PARAGRAPH 9(A) OF FINANCIAL ACCOUNTING STANDARDS BOARD STATEMENT NO. 140, Auditing Interpretation No. 1 of Statement of Auditing Standards No. 73 (Am. Inst. of Certified Pub. Accountants 1998), *reprinted in* AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, 1 PROFESSIONAL STANDARDS, at AU § 9336 (2001).

114. SFAS 140, *supra* note 11, § 9(b).

115. *Id.* § 161.

116. *Id.*

117. *Id.* § 9(b).

118. *Id.* § 29.

According to the third requirement in SFAS 140, a true sale cannot occur unless the transferor does not maintain "effective control" over the assets transferred. Two ways of maintaining effective control that SFAS 140 identifies include: (1) an agreement between a transferee and a transferor that permits the transferor to repurchase the transferred assets prior to their maturity; or (2) the unilateral ability of the transferor to cause a beneficial interest holder to return the asset, other than through a cleanup call.[119] Whereas the second part of the true sale definition focuses on the transferee's rights with respect to the assets, the third part of the definition looks at a transferor's ongoing rights and liabilities with respect to the assets.[120] Although a transferor cannot exert effective control of the assets, it can make an agreement to repurchase the assets from the transferee so long as: (1) the transferor does not purchase assets substantially the same as the ones transferred;[121] (2) the transferor does not purchase the assets on terms substantially similar to the initial terms; (3) the transferor does not purchase the assets at a fixed or determinable price if purchased before maturity; and (4) the transferor does not make the agreement concurrent with the transfer of assets.[122]

Many transfers of assets in asset-backed securitizations involve ROAPs that allow the transferor to remove accounts, and the definition of a sale in SFAS 140 permits such involvement by the transferor subject to a few limitations.[123] Issues with ROAPs frequently arise in credit card transactions, where a need often exists for the removal of certain receivables due to originator decisions to exit a business or to provide workout flexibility.[124] According to SFAS 140, effective control would exist if the ROAP allowed the transferor to specify the removed assets or if the ROAP contained a condition of removal upon a transferor's decision to exit some portion of its business because both of these would represent a unilateral ability by the transferor to remove assets.[125] SFAS 140 does permit ROAPs in certain circumstances to allow for a limited and random removal of assets,[126] removal of defaulted receivables (resulting from a third party's action), or removal conditioned on third-party cancellation (e.g. an affinity or private-label arrangement that a transferor could not unilaterally cause).[127] Anything beyond these circumstances or within the control of the transferor would represent more than a

119. *Id.* § 9(c). A cleanup call is defined as follows:

An option held by the servicer or its affiliate, which may be the transferor, to purchase the remaining transferred financial assets, or the remaining beneficial interests not held by the transferor, its affiliates, or its agents in a qualify special purpose entity (or in a series of beneficial interests in transferred assets within a qualifying SPE), if the amount of outstanding assets or beneficial interests falls to a level at which the cost of servicing those assets or beneficial interests becomes burdensome in relation to the benefits of servicing.

SFAS 140, *supra* note 11, § 364.

120. *See* MARTY ROSENBLATT ET AL., SECURITIZATION ACCOUNTING UNDER FASB 140, 10 (2d ed., 2002), *available at* http://www.deloitte.com/dtt/cda/doc/content/FAS140.pdf (last visited Apr. 15, 2004).

121. The characteristics of the asset to meet the substantially same criterion include: 1) the same primary obligor; 2) identical form and type so as to provide the same risks and rights; 3) the same maturity 4); identical contractual interest rates; 5) similar assets as collateral; 6) the same aggregate unpaid principal amount or principal amounts within accepted "good delivery" standards for the type of security involved. SFAS 140, *supra* note 11, § 48.

122. *Id.* § 47.

123. *Id.* § 87(a).

124. *See* ROSENBLATT ET AL., *supra* note 120, at 23–24.

125. SFAS 140, *supra* note 11, § 86.

126. SFAS 140 provides the example of limiting the removal to "the amount of the transferor's retained interest and to one removal per month." *Id.* § 87(a).

127. *Id.* § 87.

"trivial benefit" to the transferor and likely would not constitute a true surrender of control of the assets by the transferor to warrant derecognition and transfer of the assets.

Under the true sale definition, SFAS 140 does permit transferors to maintain a *right* to reacquire transferred assets (e.g. via an option) so long as the option does not represent effective control over the asset.[128] Typically, effective control exists when the transferred assets have an attached call[129] as opposed to an embedded call[130] because the attached call gives the transferor "the ability to unilaterally cause whoever holds the specific asset to return it."[131] In addition, any ability of the transferor to repurchase the assets either via an attached or an embedded call would qualify as effective control if the call option permitted the transferor to purchase an asset at a fixed or determinable price because this represents more than a trivial benefit to the transferor.[132] On the other hand, an option to repurchase assets at fair value would not represent effective control, unless the transferor retained a residual interest that would enable it to recoup the value by virtue of holding a subordinated interest in the assets.[133] Thus, depending on the circumstances, a call provision representing effective control by the transferor could result in a partial sale and partial financing, with those assets subject to the call remaining on the balance sheet of the transferor.[134]

SFAS 140 provides a special means of establishing a true sale of assets in asset securitization by providing a three-part definition that focuses on the transferor and transferee's degree of control with respect to the assets. As a result of the transfer, new assets and liabilities emerge and the difference between the two produces the resulting revenue or gain associated with a particular transaction. Depending on the measurement of the assets and liabilities, the corresponding income recognized from the transaction can vary.

*B. Recognition of Assets and Liabilities*

As with the foundational concept of revenue recognition, no definitive guidance exists regarding how to recognize assets and liabilities; instead the various pronouncements and accounting literature often contain vague or inconsistent standards. SFAC 6 provides the basic conceptual framework and discussion for what constitutes an asset and a liability (described in terms of economic benefits).[135] The industry specific standards and subsequent pronouncements often construe this conceptual guidance differently, however, depending on the context. One overarching theme that does appear throughout the accounting standards involves the principle of conservatism—the ten-

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128. *Id.* § 50.

129. An "attached call" represents a call attached to a particular asset transferred which would preclude an individual holding an interest in the asset from pledging or exchanging it. *See id.*

130. An "embedded call" on the other hand typically arises from the issuer putting a restriction on the financial instruments issued in the form of a callable or prepayable mortgage loan. A transferor would not have unilateral control over the assets with an embedded call. *See* SFAS 140, *supra* note 11, § 50.

131. *Id.*

132. *Id.* § 52.

133. *Id.* § 53.

134. *See* FASB SPECIAL REPORT QUESTION & ANSWER GUIDE TO IMPLEMENTATION OF STATEMENT 140, Questions 49 and 50 (Financial Accounting Standards Bd. 2001) [hereinafter SFAS 140 Q&A] (describing circumstances under which a call option results in a sale of part of the assets and when sale accounting may still occur).

135. *See supra* Part IV.A.1.

dency not to overstate assets or income and to appropriately reflect liabilities when they arise.

In building upon the economic benefits view encompassed in SFAC 6, the method for recognizing assets and liabilities set forth in SFAS 140 uses a "financial-components" approach. Under this approach, the transfer of assets from transferor to transferee in an asset securitization results in a derecognition of assets and liabilities in exchange for cash and the creation of new and distinct assets, liabilities, and associated gains or losses, all recognized at fair value at the time of the transfer and all unique in terms of traditional assets and liabilities associated with sales. These assets might include servicing assets or liabilities, recourse obligations, residual interests, call options, and interest rate swaps. Because recourse obligations and call options can often present difficulties from a legal true sale analysis, however, the bulk of asset securitization transactions typically involve servicing assets and residual interests. For instance, the transferor could retain a residual subordinated interest in the beneficial interests issued by the transferee to offset any shortfalls that might arise from uncollected assets. A transferor will often agree to service the assets on behalf of the transferee and, therefore, the transferor recognizes a servicing asset (or liability) equivalent to the estimated amount of income (or loss depending on the costs of servicing) associated with servicing the assets.[136]

The recognition of assets and liabilities at the time of transfer requires the ability of a transferor to estimate their fair value. The preferred method of valuation requires quoted market value of the instruments or a consideration of prices for similar assets and liabilities. Other valuation techniques include the objective analysis based upon models such as "present value of estimated cash flows, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis."[137] In addition, for valuing liabilities, the measure should consist of an objective estimate of the value of assets required to "(a) settle the liability with the holder or (b) transfer a liability to an entity of comparable credit standing."[138] Moreover, under principles of conservatism, a transferor should recognize the value of an asset at zero if unable to estimate its fair value, and the transferor cannot recognize a gain if unable to estimate the fair value of its liabilities.[139]

Essentially, the amount of gain recognized in a particular asset securitization transaction represents the difference between the net proceeds on assets sold and the carrying amount of those assets. For instance, say that an originator has decided to sell a pool of assets that have a net carrying amount[140] on its books of $99,000,000, and the fair value of those assets, including the retained residual interest, is $102,500,000 (assume fair market value of the residual interest is $2,500,000).[141] In addition, the transferor will also provide the servicing of these assets, and the servicing asset carries a fair market value of $700,000.[142] Also, assume that the net proceeds for the sale are $98,800,000

136. *See* SFAS 140, *supra* note 11, §§ 61–63.
137. *Id.* § 69.
138. *Id.* § 69.
139. *Id.* § 71.
140. Net carrying amount equals the sum of the principal amount of the assets, accrued interest, purchase premium, and deferred origination cost minus deferred origination fees, purchase discount, and loss reserves). *See* ROSENBLATT ET AL., *supra* note 120, at 38.
141. *See id.* (providing a similar example).
142. *Id.*

(net of transaction costs such as legal and accounting fees).[143] To calculate the gain on the transaction, an accountant would allocate relative values of the retained residual interest and the servicing assets against the carrying amount of the assets sold. These allocated amounts would get deducted from the total assets sold which in turn is deducted from the net proceeds to arrive at a gain of $2,869,767, calculated as follows: [144]

| **Component** | **Fair Value** | **% of Total Fair Value** | **Alloc. Carrying Amt. (Carrying Amt. x %)** | **Sold** | **Retained** |
|---|---|---|---|---|---|
| Servicing | $700,000 | 0.68% | $671,512 | | $671,512 |
| Assets Sold | 100,000,000 | 96.90% | 95,930,233 | 95,930,233 | |
| Resid. Interest | 2,500,000 | 2.42% | 2,398,256 | | 2,398,256 |
| **TOTAL** | $103,200,000 | 100.00% | $99,000,000 | $95,930,233 | $3,069,767 |
| Net Proceeds (after $1.2 million transaction costs) | | | | 98,800,000 | |
| **Pre-Tax Gain** | | | | **$2,869,767** | |

In addition, the corresponding journal entries for this transaction would appear as follows: [145]

| | **DEBIT** | **CREDIT** |
|---|---|---|
| Cash | $98,800,000 | |
| Servicing Asset | 700,000 | |
| Residual Interest | 3,069,767 | |
| Net Carrying Value of Loans | | $99,000,000 |
| Pre-Tax Gain on Sale | | 2,869,767 |

Depending on the fair value method used in these transactions, the resulting amount of income or revenue (e.g. the difference between the proceeds and the carrying value of the assets) could potentially change. In addition, because the valuation of the residual interest security follows the accounting guidance under Statement of Financial Accounting Standards No. 115 (SFAS 115),[146] the residual interest asset on the transferor's balance sheet immediately increases by an adjustment to the fair value of the security interest, with the corresponding increase recorded in the company's equity or the company's net income, depending on whether classified as an available-for-sale or trading asset.[147] Hence, the fair value method utilized by the transferor plays a critical role in the appearance of the financial statements.

143. *Id.*
144. *Id.*
145. *Id.*
146. ACCOUNTING FOR CERTAIN INVESTMENTS IN DEBT AND EQUITY SECURITIES, Statement of Financial Accounting Standards No. 115 (Financial Accounting Standards Bd. 1993) [hereinafter SFAS 115].
147. *See* ROSENBLATT ET AL., *supra* note 120, at 38. SFAS 140 remains silent on how to account for residual interests other than saying to reflect the interest at fair value. *See* SFAS 140, *supra* note 11, § 10. However, the implementation guidance for SFAS 140 states that retained interests should be subsequently measured like "investments in debt securities classified as available-for-sale or trading under Statement 115." SFAS 140 Q&A *supra* note 134, question 58.

SFAS 140 and the SFAS 140 Implementation Q&A provide guidance as to the subsequent measurement of the assets and liabilities after the asset securitization has occurred. For instance, for a servicing asset, SFAS 140 explicitly states that the amount of servicing income realized should be amortized over the estimated period of servicing, with any impairment or increased obligation associated with servicing the asset reflected as a write down of the asset and corresponding expense to the income statement.[148] Similarly, the transferor should also reassess the value of the residual interest on its balance sheet for impairment in its fair value and reflect any adjustments for realized gains or losses on the company's income statement, consistent with the guidance set forth in SFAS 115.[149] Depending on the fair value methods used initially in a transaction, a transferor might have to reflect significant changes in subsequent reporting periods to reflect the actual results of a securitization and for changes in valuation estimates. Therefore, SFAS 140 provides the potential for impacting a company's operating results depending on the fair valuation methods used at the onset of a sale for measurement of the residual interest retained, which could also affect the income realized by an originator positively or negatively in subsequent periods.

### C. *The Qualifying Special Purpose Entity (QSPE) and Consolidation Issues*

SFAS 140 also diverges from traditional accounting standards in its consolidation guidance for the assets and liabilities of SPEs. The American Institute of Certified Public Accountants' (AICPA)[150] Accounting Research Bulletin No. 51 (ARB 51) originally set forth the requirements for consolidation, namely that an entity with a controlling financial interest in another entity must consolidate the entity onto its financial statements.[151] However, due to manipulation of the voting control and other outside equity investment requirements by companies such as Enron, the FASB has recently responded by issuing an Interpretation of ARB 51, FASB Interpretation No. 46 (FIN 46), which refines the principles involved in considering when to consolidate entities.[152] FIN 46 represents a shift from equity ownership and controlling interest requirements to a risk and reward model that focuses on the primary beneficiary of a particular entity's operations to determine whether to consolidate.[153] Ordinarily, the decision to consolidate an SPE would fall subject to consolidation requirements of FIN 46; however, FIN 46 presently carves out an exception for any SPE qualifying as a qualifying special purpose entity (QSPE) and, therefore, leaves issues regarding the treatment of QSPEs to SFAS 140.[154] Hence, by providing further specific standards, an asset securitization under the current accounting standards permit non-consolidation of assets and liabilities of an otherwise related entity (SPE), so long as the entity meets certain requirements.

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148. *See* SFAS 140, *supra* note 11, §§ 13, 61–64.

149. *See* SFAS 115, *supra* note 146, §§ 13, 16–18.

150. Prior to the formation of FASB, the AICPA established several committees to establish accounting standards, including the Accounting Research Bulletins (ARB's) and Accounting Principles Board Opinions (APB's). HERWITZ & BARRETT, *supra* note 8, at 152–53.

151. *See* CONSOLIDATED FINANCIAL STATEMENTS, Accounting Research Bulletin No. 51, § 2 (American Inst. of Certified Pub. Accountants 1959) [hereinafter ARB 51] *superseded by* CONSOLIDATION OF ALL MAJORITY-OWNED SUBSIDIARIES, Statement of Financial Accounting Standards No. 94 (Financial Accounting Standards Bd. 1987).

152. *See* FIN 46, *supra* note 74, § 1.

153. *Id.* § C29.

154. *See id.* § 4(c).

As opposed to evaluating an entity by weighing risks and rewards associated with it, the requirements of SFAS 140 essentially provide a "bright-line" four-part standard for achieving QSPE status. Despite the transferor's continuing involvement as previously described (i.e. through servicing, removal of accounts, or other continuing involvement), the pronouncement once again differs from the traditional and now reformulated concepts of risks and rewards analysis in the accounting principles for determining when to consolidate an entity. Instead, SFAS 140 focuses on the functions of the SPE and types of assets the entity holds. According to the requirements of SFAS 140, a QSPE should essentially operate under "automatic pilot" status and perform or undertake extremely limited functions.[155] In restricting these functions and the incurred indebtedness to only the securitization, these restrictions minimize the risk that the SPE itself would have obligations to anyone but its own investors.[156]

In addition to limiting the functionality to protect assets from bankruptcy risk, the four requirements in SFAS 140 for QSPE status also ensure isolation of the assets from the bankruptcy risk of the transferor by ensuring that the transferor has limited control over the entity and does not derive any benefits that would possibly warrant consolidation. For instance, a QSPE requires a demonstrably distinct existence from the transferor.[157] SFAS 140 states that an SPE satisfies this requirement if the transferor cannot unilaterally dissolve it and outside parties own no less than ten percent of the beneficial interests at all times.[158] SFAS 140 also limits the SPE's activities to only those activities specified in advance at formation of the entity.[159] Only the majority approval of the beneficial interest holders can change the permissible activities.[160] Additionally, a QSPE can only hold certain types of assets, typically passive in nature.[161] Finally, the QSPE can dispose of assets in only limited circumstances, essentially those associated with activities specified at the inception of the transaction, such as removal of accounts provisions, clean-up calls, termination of the entity, or exercise of a put by a third-party beneficial interest.[162] Not only do these requirements limit the activities of the QSPE but they also provide a check against the unilateral control of the transferor and ensure that the QSPE exists for the benefit of the beneficial interest holders. Thus, if an SPE can meet all of these control and activity limitations, it will qualify as a QSPE and will avoid the requirement of consolidation analysis under FIN 46 because SFAS 140 exempts all qualifying QSPE transactions from FIN 46.[163]

### *D. Summary of Conflicts with Traditional Accounting Principles*

Clearly, SFAS 140 contains several exceptions that present deviations from traditionally accepted accounting principles. In a post-Enron world in which Congress, the SEC, and the FASB have expressed a preference for "principles-based" or "objectives-

155. *See* Rosenblatt & Johnson, *supra* note 42, at 806.
156. *Id.* at 804.
157. SFAS 140, *supra* note 11, § 35(a).
158. *Id.* § 36.
159. *Id.* § 35(c).
160. *Id.*
161. *Id.* § 35(c). These assets include passive financial assets transferred to it, derivative financial instruments, guarantees, related servicing rights, cash and temporary investments for distribution to security holders, and similar instruments. *See id.*
162. SFAS 140, *supra* note 11, § 35(d).
163. *See id.* § 46.

oriented" accounting standards, SFAS 140 presents a potential roadblock with its checklist type of standards. Instead of more generally comporting with traditional risk and rewards notions associated with recognizing a sale of assets as advocated in legal and other accounting analysis, the "control-based" model of SFAS 140, which focuses solely on the party's ability to control an asset, chooses not to look at risk and the concept of substantial completion in characterizing the true sale of assets. SFAS 140 can also present potential short-sighted behavior depending on a transferor's method of valuation and resulting gain realized in an asset securitization transaction. This potential for income maneuvering could possibly paint a misleading picture as to the actual financial performance of a company. For instance, Enron's manipulation of six accounting techniques produced ninety-six percent of its net income in the year 2000.[164] In addition, parties with closely-related transactions and functions often require consolidation under typical accounting standards. But by providing a checklist definition of entity formation that permits ongoing involvement by the transferor, SFAS 140's concept of consolidation also does not comport with "principles-based" standards. The more that the provisions of SFAS 140 reflect rules or special exceptions that tend to contradict the ongoing objectives and conceptual framework of accounting, the more likely SFAS 140 may require a complete overhaul.[165]

## V. CURRENT TRENDS IN THE ACCOUNTING INDUSTRY

The FASB has effectively established a framework in which an enterprise seeking to do an asset securitization can structure the transaction in a variety of ways and still recognize income from the transaction and obtain off-balance sheet treatment of the corresponding assets and liabilities. Although this framework arguably serves as the most appropriate treatment for the majority of these transactions because the obligation rests solely with the bankruptcy-remote entity for the purpose of investors and, as such, should no longer appear on the originator's financial statements, the benefits associated with such segregation can also create an incentive for companies to use off-balance sheet financing for potentially manipulative or misleading purposes. For instance, in the most recent case of Parmalat, the Italian dairy company that recently declared bankruptcy, the company used a variety of securitizations in which it booked income at the operating-company level based upon forged invoices representing the accounts receivable presumably sold.[166]

To the extent that these transactions represent ongoing involvement in terms of continuing obligations of the originator that require revaluation and ongoing adjustments to

164. Batson Report, *supra* note 71, at 21. These techniques included SFAS 140 transactions, tax transactions, non-economic hedges, share trust transactions, minority interest transactions, and prepay transactions. *Id.* at 21–23.

165. As noted previously, FASB has released an Exposure Draft with proposed changes to SFAS 140. The proposed changes include possibly limiting recourse obligations by the transferor and the types of assets that a QSPE can hold. *See* Exposure Draft, *supra* note 74. The Board also considered requiring a QSPE in the two-tier transaction to meet the requirements of a true sale. *See* Qualifying Special-Purpose Entities and Isolation of Transferred Assets, FASB Project Update, *at* http://www.fasb.org/project/qualifying_spe.shtml (last visited Apr. 15, 2004) [hereinafter QSPE Project]. The Board plans to come out with a revised Exposure Draft in the third quarter of 2004. *See id.* At this time FASB has not provided a strong indication whether it will completely change the statement to conform to FIN 46 principles of risks and rewards.

166. Fred Kapner et al., *Parmalat investigators probe role of Citigroup executives*, FIN. TIMES, Jan. 14, 2004, at 21.

income, accounting rule makers cannot help but ask the question whether the financial components approach embodied by SFAS 140 represents the most appropriate depiction. Moreover, recent deliberations on the part of the FASB, the IASB, and the SEC seem to suggest that changes in financial accounting for securitizations will likely occur. For instance, in June 2003, the FASB released an Exposure Draft revealing controversial amendments to SFAS 140 in an effort to conform to many of the principles embodied in FIN 46.[167] With a second Exposure Draft charted for release in the third quarter of 2004,[168] and a Final Draft expected to follow shortly thereafter, it becomes a question of whether amendments to the existing framework will prove sufficient or whether the FASB should instead embrace a completely new approach to accounting for securitizations. In December 2003, the IASB released a revised pronouncement—International Accounting Standard 39 (Revised IAS 39)—that will become effective beginning in January 1, 2005 and which industry observers believe will require more companies to keep portions of these transactions on their balance sheets due to the ongoing involvement of the transferors.[169] The IASB revisions prove important because, according to the Short-Term International Convergence Project between FASB and the IASB, the FASB will seek to conform its standards as closely to the International Standards on the topic of financial instruments.[170] In the interim, although the SEC does not mandate the recognition of these transactions on the balance sheets of originators, a provision in the Sarbanes-Oxley Act does require an extensive discussion of the off-balance sheet arrangements and related assets and liabilities in the Management, Discussion and Analysis (MD&A) section of publicly-traded companies' financial reports.[171] Obviously, it is clear that more disclosure is now required. But the question remains whether footnote disclosure or balance sheet presentation is the more appropriate place.

### *A. Recent Decisions by FASB*

FASB has actively sought to address many of the defects in its financial reporting standards as a result of all of the financial scandals of late. FIN 46 represents one of the most significant and controversial changes to come from the private standard setter. FIN 46 provides a clarification of accounting principles of consolidation that requires an analysis of risks and rewards borne by related entities, which never before existed.[172] The ideas behind this interpretation arguably stem from abuses in the Enron debacle in which the company set up separate special purpose entities but did not include them in the company's consolidated financial statement even though the company assumed a majority of the risk in the activities of the special purpose entities.[173] As a result, Enron showed substantial income and gains from these unconsolidated entities with no corre-

167. *See* Exposure Draft *supra* note 74, § A9.

168. *See* Project Updates and Technical Plan, Summaries of Agenda Projects, *at* http://www.fasb.org/project/ (last visited Apr. 15, 2004).

169. Marty Rosenblatt & Jim Mountain, *Accounting for Securitisation Transactions Under the New Revised IAS 39: Good News or Bad News*, 9 SPEAKING OF SECURITIZATION 1 (Deloitte and Touche Jan. 2004), *available at* http://www.deloitte.com/dtt/cda/doc/content/vol9%231.pdf (last visited Apr. 15, 2004).

170. *See* International Convergence Project, *supra* note 75.

171. *See* Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, 68 Fed. Reg. 5982 (Feb. 5, 2003) (to be codified at 17 C.F.R. pts. 228, 229 & 249).

172. *See* FIN 46, *supra* note 74, at §§ 1, 5–8.

173. *See* Feldkamp, *supra* note 12.

sponding identification of the liabilities that continued to exist on the part of Enron.[174] Presently, FIN 46 provides a special exemption for SPEs that qualify as a QSPE and leaves the rules governing these entities to SFAS 140; however, this treatment remains subject to change.[175]

In light of FIN 46, FASB has reconsidered how SFAS 140 should operate considering these recent abuses. In June 2003, FASB released an Exposure Draft of proposed amendments to SFAS 140 with two main objectives:

> 1) prevent derecognition by transferors that may continue to retain effective control of transferred assets by providing financial support other than a subordinated retained interest or making decisions about beneficial interests; and 2) help ensure that SPEs will not qualify for the exception to [FIN 46] if any party involved is in a position to enhance or protect the value of its own subordinated interest by providing financial support for or making decisions about reissuing beneficial interests.[176]

To fulfill these objectives, the major changes advocated in the first Exposure Draft include a prohibition of QSPE status if a transferor or affiliate provides any agreement to provide or deliver additional cash or other assets to an SPE—including liquidity commitments, financial guarantees, and written options or commitments to repurchase beneficial interests.[177] In addition, a transferor or any consolidated affiliate cannot serve as a counter-party on any type of derivative support to the SPE, and the QSPE cannot hold equity instruments of any kind.[178] The Exposure Draft places even more restrictions on entities that involve revolving structures in which the reissuance of beneficial interests occurs on an ongoing basis.[179] Finally, in a two-tier structure the FASB would require QSPE status of the second entity.[180]

The proposed changes elicited comment letters from 52 industry participants, all criticizing the FASB's attempt to mesh two conflicting principles within one standard: the concept of what constitutes control versus a risk and rewards type of concept.[181] Several of the comment letters instead advocate carve-outs for certain types of permitted guarantees, derivatives, and reissuance of beneficial interests that might not represent control by the transferor.[182] In the alternative, some comment letters argued that without

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174. *Id.*

175. *See* FIN 46, *supra* note 74, § 4(c).

176. Exposure Draft, *supra* note 74, at ii.

177. *Id.* § 35(e).

178. *Id.* §§ 35(c)(2), 35(c)(1).

179. For instance, if a QSPE has the ability to reissue beneficial interests, no party can provide a commitment to deliver cash for more than half of the fair value of the commitments of the SPE, no party can make a decision about reissuing beneficial interest and provide any commitment to deliver cash, and if a party holds a subordinated interest, it cannot provide a commitment to deliver additional cash. This would essentially mean that a transferor could not provide any liquidity support and still retain a subordinated retained interest (credit card transactions often require liquidity support due to the fluctuating nature of the balances). *See id.* § 35(f).

180. *Id.* § 83.

181. *See generally* Industry Comment Letters, *at* http://www.fasb.org/ocl/1200-001/16217.pdf (last visited Apr. 15, 2004).

182. *See, e.g.*, Comment Letter dated July 28, 2003 written by Vernon H.C. Wright of the American Securitization Forum and Esther Mills of the Bond Market Association to FASB regarding the Exposure Draft, *at* http://www.fasb.org/ocl/1200-001/16217.pdf (last visited Apr. 15, 2004) [hereinafter American Securitization Forum Letter]; *see also* Comment Letter dated July 29, 2003 written by David S. Moser of Morgan Stanley to FASB regarding the Exposure Draft, *at* http://www.fasb.org/ocl/1200-001/16248.pdf (last visited Apr. 15, 2004), Comment Letter dated Aug. 4, 2003 written by Robert Uhl of Deloitte and Touche to FASB regarding the Exposure Draft, *at* http://www.fasb.org/ocl/1200-001/16584.pdf (last visited Apr. 15,

incorporating these carve-outs, FASB should completely abandon the statement altogether in lieu of one overarching statement regarding sales and consolidation.[183] FASB has considered these comments, and has initiated several inquiries into these issues, the results of which will appear in the second Exposure Draft scheduled for release by third quarter 2004.[184] In addition, preliminary indications seem to suggest that the FASB will revise its restrictions on the limitations placed on transactions involving liquidity support involving the reissuance of beneficial interests (e.g. revolving transactions) so long as the benefits realized do not exceed the benefits of any other party.[185] The FASB may also further distinguish types of guarantees to still achieve QSPE status, such as warranties, representations and passive derivative instruments.[186] Other recent proposals include the possible requirement of valuing of beneficial interests and mortgage servicing rights at fair value.[187] If the Final Draft (that will likely follow the second Exposure Draft shortly thereafter) anywhere resembles the current proposals in the Exposure Draft, it could become increasingly difficult for an SPE to maintain qualifying status under many asset securitization structures. As a result, companies potentially would have to reevaluate the impact of the consolidation of the transaction onto its financial statements.[188]

### *B. Changes to the International Accounting Standards*

The International Accounting Standards (IAS) serve a particularly important role in assessing the appropriate accounting treatment for asset-backed securitization for two reasons. First, Revised IAS 39[189] represents the first international attempt to clarify an appropriate accounting for financial instruments including asset securitizations following the financial scandals that have occurred. Second, the SEC and FASB have recog-

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the Exposure Draft, *at* http://www.fasb.org/ocl/1200-001/16584.pdf (last visited Apr. 15, 2004) (letters advocated carve-outs for standard representations and warranties, passive derivatives and liquidity commitments).

183. *See* American Securitization Forum Letter, *supra* note 182, at 18.

184. *See* QSPE Project, *supra* note 165. For instance, most recently the FASB has determined that further information is required as to the legal isolation of the transferred assets with respect to rights of setoff between the original debtor and the transferor. The FASB has published a Request for Information that details the Board's concerns about the effect of setoff in the true sale opinion letters issued by attorneys and has asked attorneys and representatives of regulatory and rating agencies to participate in a public roundtable discussion during the second quarter of 2004. *See* FASB Request for Information, *at* http://www.fasb.org/project/staff_document_amendst140.pdf (last visited Apr. 15, 2004). The results of this discussion could potentially affect the legal isolation requirement in the three-part definition of a true sale under SFAS 140. *See supra* note 109 and accompanying text.

185. Discussion of Issues Related to Legal Isolation, Transferor Restrictions, and Equity Instruments, FASB Board Meeting Minutes at 6–7 (Sept. 24, 2003), *at* http://www.fasb.org/board_meeting_minutes/09-24-03_qspe.pdf (last visited Apr. 15, 2004).

186. Discussion of Issues Related to Transferor Support Commitments, Effective Date, Transition Provisions, the Distinction Between Undivided Interests and Beneficial Interests, FASB Board Meeting Minutes, at 4 (Oct. 1, 2003), *at* http://www.fasb.org/board_meeting_minutes/10-01-03_qspe.pdf (last visited Apr. 15, 2004).

187. *See* Beneficial Interest in Securitized Financial Assets, FASB Project Update, *at* http://www.fasb.org/project/beneficial_interests.shtml (last visited Apr. 15, 2004); Mortgage Servicing Rights at Fair Value, FASB Project Update, *at* http://www.fasb.org/project/mortgage_servicing_rights.shtml (last visited Apr. 15, 2004).

188. By failing QSPE status, the evaluation would automatically revert to consolidation principles under FIN 46, as such the SPE would likely require consolidation onto the transferor's balance sheet due to its continuing involvement. Consolidation would essentially destroy the effect of the off-balance sheet transfer by bringing both the assets and the liabilities back onto the balance sheet.

189. The IASB issued the Revised International Accounting Standard 39 *Financial Instruments: Recognition and Measurement* (Revised IAS 39) in December 2003. Rosenblatt & Mountain, *supra* note 169, at 1.

nized the importance of the principles-based objectives of the IAS and as a result, will seek to conform the United States GAAP to the International Financial Reporting Standards ("IFRS") in an international convergence project that seeks to formulate one unified set of accounting standards worldwide.[190] The recently finalized version of Revised IAS 39 appears to employ a three-part categorical analysis in determining whether to derecognize assets and liabilities associated with an asset securitization based on the risks and rewards retained. For instance, if the entity *transfers* substantially all the risks and rewards of ownership of the financial asset, the entity derecognizes the financial asset and then recognizes any associated assets or liabilities retained in the transfer (similar to the current SFAS 140 approach).[191] On the other hand, if the entity *retains* substantially all of the risks and rewards of ownership, it shall continue to recognize the financial asset and an associated liability for the proceeds.[192] Finally, if the entity neither retains nor transfers substantially all of the risks and rewards (e.g. the entity transfers a significant amount but not substantially all), then the accounting becomes much more complex and the assets and liabilities of the originator fall subject to the "continuing involvement" approach to recognition.[193]

Revised IAS 39's standards prove vague for what qualifies for a transfer of significant, but not substantially all of the risks and rewards; however, to the extent that the transferor retains any control over the transferred asset or rights to related assets (e.g. via a residual interest, or a call option), those types of interests would likely constitute continuing involvement.[194] The accounting for these interests differs from the traditional approach used by SFAS 140, where the transferor derecognizes the entire asset and instead recognizes a new asset or liability for a recourse obligation or residual interest.[195] Under the continuing involvement approach, the transferor would derecognize the asset to the extent that the transferor no longer has any obligations associated with it, but in the case where the transferor might retain an interest in the asset, the retained interest appears as a liability on the transferor's balance sheet and income from the difference between fair value and book value gets recognized over time.[196] Thus, the Revised IAS 39 approach resembles the partial sale and partial financing treatment that would occur under SFAS 140 with a call option.[197] Although the continuing involvement standard would cause the derecognition of fewer assets at the onset of the transaction, resulting in a more conservative measure of income, one associated drawback criticized in this technique concerns the double counting of assets and liabilities where they do not exist.[198]

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190. *See supra* Part IV.
191. Rosenblatt & Mountain, *supra* note 169, at 2.
192. *Id.*
193. *Id.*
194. *Id.* at 3 ("Nor did [the IASB] give bright-line guidance on the cut-off levels for 'substantially all.'").
195. *Id.*
196. *Id.* at 7.
197. *See supra* Part IV.A.2.(b).
198. *See* Comment Letter dated Oct. 15, 2002 written by Michiyoshi Sakamoto of the American Securitization Forum and Bond Market Association to IASB regarding the Exposure Draft of Proposed Amendments to IAS 23, Financial Instruments: Disclosure and Presentation, and Revised IAS 39, Financial Instruments: Recognition and Measurement, *at* http://www.americansecuritization.com/ docs/ IA32and IAS39 CommentLtr.pdf (last visited Apr. 15, 2004) [hereinafter Sakamoto Letter] (stating that the forum does not under the Revised IAS 39 approach as it "cannot explain why the transferor has two assets that simultaneously (1) represent retained interests in the transferred assets and (2) represent the unsold portion of the original assets (these stay on the balance sheet by virtue of the retained interests that are accounted for separately)." *Id.* at 3.

Industry commentators argue that "users may fail to understand that both potential risks (the unsold receivables) and future obligations (the liability) are overstated."[199]

### *C. SEC and Sarbanes-Oxley Requirements for Disclosure*

Even with the uncertainty existing in the accounting realm as to how to classify these transactions on financial statements, the SEC has taken the additional step of requiring at least disclosure of any off-balance sheet financing arrangements.[200] Although the SEC's pronouncements only apply to its SEC registrants (e.g. publicly traded companies), the decisions do offer persuasive guidance for the accounting standards that apply to all companies. According to SEC Rule 3235-AI70, after June 15, 2003, in the MD&A section of SEC registrant's annual reports, the registrant must disclose information regarding the nature of its off-balance sheet activities including information regarding:

- The nature and business purpose of the registrant's off-balance sheet arrangements;
- The importance of the off-balance sheet arrangements to the registrant for liquidity, capital resources, market risk or credit risk support or other benefits;
- The financial impact of the arrangements on the registrant (e.g., revenues, expenses, cash flows or securities issued) and the registrant's exposure to risk as a result of the arrangements (e.g., retained interests or contingent liabilities); and
- Known events, demands, commitments, trends or uncertainties that affect the availability or benefits to the registrant of material off-balance sheet arrangements.[201]

In addition, the SEC requires presentation of this information in tabular format distinguishing between the type and duration of these obligations and arrangements.[202] Thus, asset-backed securitizations would qualify as an off-balance sheet transaction that would at least require additional details in an originator's MD&A section.[203] Although the disclosure would not affect the company's operating results or financial ratios, this additional disclosure might at least bring the financing arrangement to the attention of parties, such as the originator's unsecured creditors, that might not ordinarily know about it.

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199. *See id.*

200. *See* Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, 68 Fed. Reg. 5982 (Feb. 5, 2003) (to be codified at 17 C.F.R. pts. 228, 229 & 249). The SEC rule was promulgated pursuant to a requirement of § 401(a) of the Sarbanes-Oxley Act. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 § 401(a), 116 Stat. 745 (codified in scattered sections of 15, 18, 28 and 29 U.S.C.A. (2002)).

201. 68 Fed. Reg. at 5985.

202. *Id.* at 5990.

203. According to SEC rule:

The definition of "off-balance sheet arrangement" includes any contractual arrangement to which an unconsolidated entity is a party, under which the registrant has:

- Any obligation under certain guarantee contracts;
- A retained or contingent interest in assets transferred to an unconsolidated entity or similar arrangement that serves as credit, liquidity or market risk support to that entity for such assets;
- Any obligation under certain derivative instruments;
- Any obligation under a material variable interest held by the registrant in an unconsolidated entity that provides financing, liquidity, market risk or credit risk support to the registrant, or engages in leasing, hedging or research and development services with the registrant.

*Id.* Therefore, most securitizations would likely fall under these categories.

### D. "Matched Presentation": A Potential Compromise?

With the uncertainty surrounding FASB's final decision regarding the accounting treatment of asset securitizations and the somewhat contradictory treatment set forth in Revised IAS 39, one cannot help but question whether a better or different solution exists for accounting for these transactions. In response to the Exposure Draft, the American Securitization Forum and the Bond Market Association (two important participants in the industry) have provided a potential alternative, a "matched presentation" approach, which could potentially resolve a lot of the issues associated with these transactions.[204] Although the two Associations continue to advocate SFAS 140 in its present form, they propose that FASB adopt a matched presentation approach as opposed to pursuing the changes proposed in the Exposure Draft.[205] The "matched presentation" approach, similar but not identical to the "linked presentation" approach used in the United Kingdom, essentially would provide a separate category of assets and liabilities on a company's balance sheet.[206] For instance, "the SPE's gross assets would be shown on a separate line, immediately followed by a deduction for non-recourse debt and third party interests issued by the SPE, arriving at the reporting entity's interest in the SPE."[207] The actual format for this would look something like the following: [208]

| | |
|---|---|
| Investment in [and advances to] Special-Purpose Entities: | |
| Gross assets managed...................................... | $100,000,000 |
| Non-recourse debt and third party equity interests..... | 90,000,000 |
| Net Investment in special-purpose entities.............. | $ 10,000,000 |

In addition, the transferor's income statement would also contain a separate section devoted to interest and other income of the SPE, "the income earned by the reporting entity from its investment in the SPE would be shown net in the income statement, with disclosure of the SPE's gross amounts of interest income, interest expense, servicing fees, bad debt losses, etc. in the notes to the financial statements."[209] Any type of recourse beyond ordinary representations and warranties would receive classification as a liability, rather than a contra asset.[210] The relative simplicity of this approach would alleviate many of the concerns about what types of activities to consolidate and what not to consolidate by instead including everything on the same financial statement; however, additional considerations would also have to take place to ensure the soundness of the structure.[211] For instance, because the assets and corresponding liability to investors would not belong to the originator (arguably only the net amount would), this could violate the traditional principles of asset and liabilities belonging to no more than one entity advocated by SFAC 6.[212] The matched presentation would more likely comport with a risk and rewards framework, however, because the resulting income from the transaction would be recognized over the life of the transaction when earned.

Other issues could potentially arise with a matched presentation approach. For instance, a company would still need to ensure that the SPE involved would continue to

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204. *See* American Securitization Forum Letter, *supra* note 182, at 18–21.
205. *Id.* at 18.
206. *Id.* at 19.
207. *Id.*
208. *Id.*
209. *Id.*
210. *See* American Securitization Forum Letter, *supra* note 182, at 21.
211. *Id.* at 20–21.
212. *See supra* Part IV.A.1.

qualify as bankruptcy-remote and beyond the reach of the reporting entity.[213] Moreover, a legal analysis still must consider the role that consolidated financial statements play in assessing possible substantive consolidation.[214] In structuring the transaction, the same limitations on recourse, liquidity support and control over the assets by the transferor would still all need to apply to meet the legal isolation requirements.[215] Although a tendency exists to lump these assets and liabilities into traditional balance sheet ratios, this would not need to occur under the matched presentation approach, as the liabilities and assets would belong to an entity other than the consolidating entity.[216]

Obviously, the matched presentation approach has its associated benefits and drawbacks. For instance, so long as companies with securitization structures conform to this method of reporting, investors, creditors, and the public would likely become more accustomed to this format and analyze it consistently. A consistent format would dissuade companies from seeking solely to impact their balance sheets for improved ratios, and it would also eliminate the ability to use securitization as a method to mask a company's operating performance by producing income at the inception of a transaction. Although the matched presentation approach would permit heightened awareness, it could also cause confusion to unsecured creditors of the originator or bankruptcy courts in assessing the ownership of the assets. Thus, it becomes a question of balancing the interests of the investors and the financial services industry against the investing public and creditors of the originator. Moreover, although the method of presentation might prove cumbersome initially to switch, the benefits of consistency and full disclosure could quite possibly outweigh the costs.

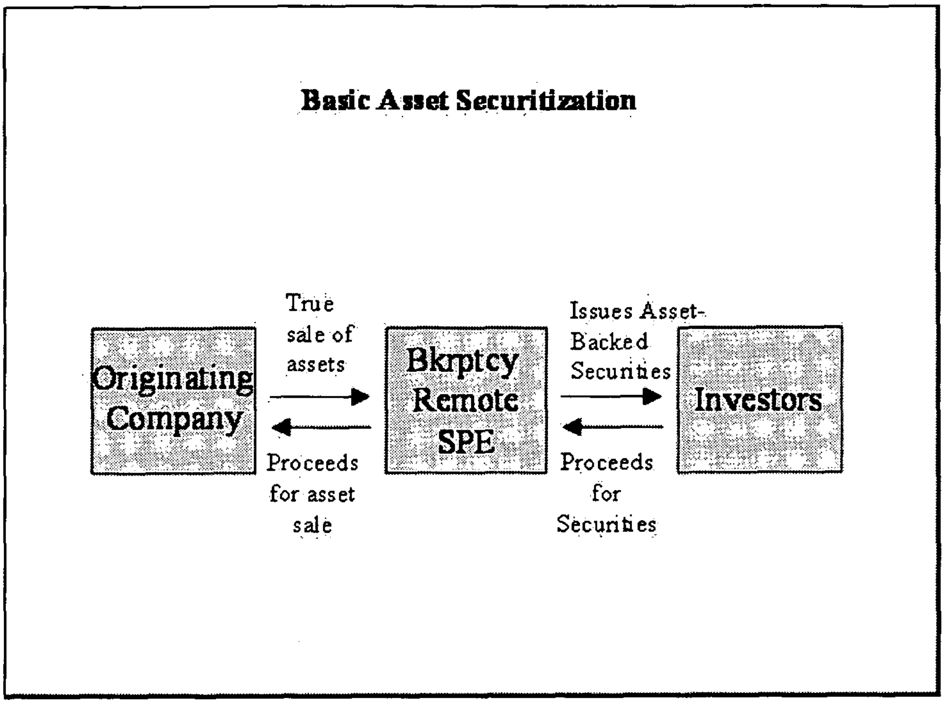
## VI. CONCLUSION

Asset securitization—a highly powerful and efficient capital raising device—requires a solid understanding of the bankruptcy and accounting issues that underlie and threaten these structures. Although the bulk of transactions work very smoothly and carry out the intended purpose of the financing vehicle, the corresponding accounting treatment leaves open potential for manipulation of financial statements. The outlook for FASB and its proposed agenda suggests that SFAS 140 in its current state will not exist for long; however, a complete overhaul of the rule at the present time remains uncertain. In a world where full disclosure has become the mantra of the financial markets, the resulting question remains what system will provide the most accurate representation while still providing the best checks and balances against fraud. For these reasons, the proposition of adopting the "matched presentation" approach to accounting could very well prove the most suitable alternative because although potentially conservative on the part of the transferor, it at least places every party on a level playing field. In the end, it becomes a question of who should bear the risk of disclosure: the investors and unsecured creditors of the originator or the originators themselves. Although far from an easy question, an understanding of the tensions within these transactions helps

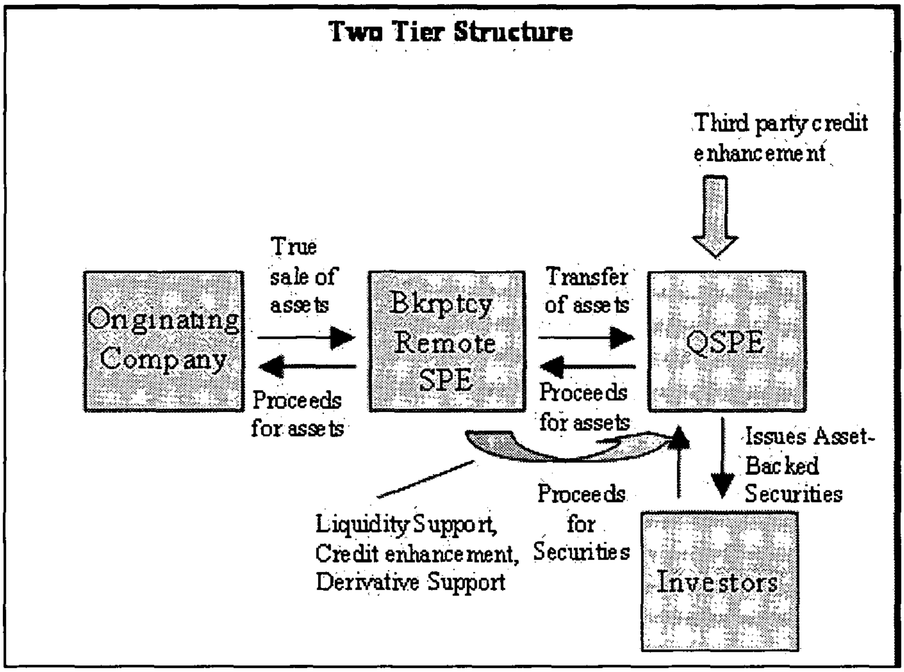
213. *See* American Securitization Forum Letter, *supra* note 182, at 20.
214. *See supra* text accompanying note 59.
215. *See* American Securitization Forum Letter, *supra* note 182, at 21.
216. *Id.* at 20.

one appreciate the issue at stake, and, ultimately posits whether this highly efficient industry should bear the burden of a few bad incidents.

APPENDIX A


Basic Asset Securitization
Originating Company
True sale of assets
Proceeds for asset sale
Bkrptcy Remote SPE
Issues Asset-Backed Securities
Proceeds for Securities
Investors

## APPENDIX B


Two Tier Structure
Third party credit enhancement
True sale of assets
Originating Company
Proceeds for assets
Bkrptcy Remote SPE
Transfer of assets
Proceeds for assets
QSPE
Issues Asset-Backed Securities
Proceeds for Securities
Liquidity Support, Credit enhancement, Derivative Support
Investors