



# Legal Isolation in Accounting Sales

## The Lawyer's Perspective

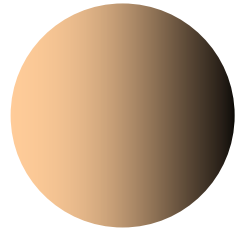
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# The Essence of the Issue

Accountants are from Mars.



Lawyers are from Venus.



# Venus and Mars cont'd

- Approach to entities within a control group:
  - Accounting requirement to consolidate
- vs.
- Legal presumption of separateness
  - Substantive consolidation as the exception
- Legal opinions/consensus vs. GAAP
  - Diverse sources of case law – 100s of courts
  - No FASB to deal with differences in practice

# Venus and Mars cont'd

## – Consequence:

- General consensus among lawyers as to what factors are important in a true sale or substantive consolidation analysis

**BUT**

- Differences among firms as to tolerance for divergence from the most conservative positions

# Legal True Sale Factors

- Intent
  - Necessary but usually not sufficient
  - Nice to have a clear and definitive statement
  - At the least, terminology should be consistent with sale and purchase
  - No conflicting statements, **but**
  - UCC backup security interest is not viewed as materially inconsistent

# Legal True Sale Factors

- Economic consequences
  - Substance over form
  - Risk of loss/recourse
    - FFIEC definition of recourse: retained disproportionate risk of loss
    - Examples:
      - Repurchase obligations (but consider early payment defaults and premium recapture provisions)
      - Subordinated retained interests (but different if held by bankruptcy remote affiliate)
      - Servicer advances if not limited and/or entitled to reimbursement
      - Indirect: letter of credit/reimbursement obligation
      - Credit default swaps

# Legal True Sale Factors

- Economic consequences cont'd
  - Rights to benefits
    - Calls (relevant to accountants under 9(c), but lawyers also consider under 9(a))
    - Retained residual interests (outside of bankruptcy remote affiliates)
  - Servicing retained vs. released
    - Retained ok, subject to recourse issues
    - Active market for servicing rights is helpful but not generally essential

# Banks vs. Non-Banks

- Banks
  - FDIC
  - Federal Deposit Insurance Act
  - FDIC Rule
  - Repudiation
- Non-Banks
  - Trustee or debtor in possession
  - Bankruptcy Code
    - Automatic stay
    - Substantive consolidation

# Affiliates

- Possibility of substantive consolidation if buyer and seller are related
  - What it means: pooling of assets and liabilities across entities
  - When does it happen?
    - “Sparingly” and in “rare cases”
    - Messy housekeeping: affairs “hopelessly obscured”
    - Did creditors view as single entity?
    - Weighing equities – protecting reliance expectations
    - Owens, Corning
- Outside chain of title structures