Consolidating Weakness:
Accounting Rules on Consolidation and the Subprime Crisis

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I. INTRODUCTION

a. Accounting rules played a critical role in the "subprime" crisis, but attention has focused primarily on the debate on revising the "mark-to-market" rules.
b. Policymakers have not adequately addressed accounting rules on consolidation, which govern both:
    i. When an originator (or other owner) of mortgages and loans that it "transferred" to a special purpose entity (SPE)[1] to be securitized can account for that transfer as a sale; and
    ii. When an investor who purchased, or a guarantor who guaranteed, asset-backed securities from an SPE must consolidate that SPE into its financial statements.
c. Two core questions:
    i. To what extent did the desire to avoid consolidation drive securitizations at the heart of the crisis?
    ii. To what extent would stricter consolidation rules have mitigated some of the damage from the crisis?
d. Unfortunately, reinterpretations of the consolidation rules – to further crisis management goals (for example, to allow for mortgage modification) or to remedy perverse incentives of lenders created by securitization – may further undermine the vital role of consolidation in disclosure and regulation.
e. Beyond the immediate crisis,
    i. Accounting is a critical entry point for *intradisciplinary* legal scholarship that integrates business associations and other fields of business law.
    ii. Transactional scholarship, including that with an accounting component, provides an ideal intradisciplinary vehicle that can connect not only to legal practice, but cutting edge policy issues as well.

II. CONSOLIDATION REPRESENTS BEDROCK PRINCIPAL FOR FINANCIAL REPORTING

a. The objective is to ensure that a firm's financial statements include its subsidiaries.
b. Understanding a firm's entire financial position is critical for
    i. Disclosure to investors and creditors; and
    ii. Regulation, particularly of financial institutions.
c. Non-consolidation was abused by Enron with "off-balance sheet" financing.

III. NON-CONSOLIDATION IN SECURITIZATION

a. Enron fraud led to the reform of accounting rules on consolidation.
b. Securitization poses two questions:
    i. Will the originator/transferor of mortgages (or other loans being securitized) be able to account for their transfer as a sale?

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[1] These entities are sometimes referred to as special purpose vehicles (SPVs) or similar terms. I use "SPE" to match the relevant accounting terminology.

   ii. Will an investor, sponsor, or guarantor of a securitization be required to consolidate the SPE (*i.e.*, the issuer of the asset-backed securities) in its financial statements?

c. Two principal rules:
   i. Financial Accounting Statement Number 140 ("FAS 140")[2]
      1. Basic standard
         a. The transfer of mortgages (or other loans) by originators (or other transferors) to a securitization vehicle qualifies for sale accounting only if the transferor surrenders control over the transferred assets.[3]
         b. The transferor must also receive consideration "other than beneficial interests."
      2. Creation of Qualified SPEs ("QSPEs")
   ii. FASB Interpretation Number 46 (Revised) ("FIN 46(R)")[4]
      1. Basic rule:
         a. A variable interest entity ("VIE") must be consolidated with it's a primary beneficiary.
         b. QSPEs are exempt from consolidation.
      2. Definitions:
         a. A "VIE" is an organization with either
            i. insufficient equity capital to absorb expected losses or finance its activities; or
            ii. equity investors that have restricted rights or obligations compared to traditional equity securities.[5]
         b. The "primary beneficiary" is the organization that would absorb the *majority* of a VIE's expected losses.
d. The role of law and lawyers
   i. FAS 140 relies heavily on analysis of bankruptcy law, which in turn looks to corporate law on key questions.
      1. To qualify for sale accounting, the transferred assets must be isolated from the transferor and presumptively beyond the reach of the transferor and its creditors, even in bankruptcy.
      2. Substantive consolidation occurs when a bankruptcy court exercises its equitable powers under Section 105(a) of the Bankruptcy Code. Courts may apply several tests:
         a. Under one set of tests, courts ask whether "a corporation is a mere instrumentality or alter ego of the bankrupt corporation."[6]
            i. This mirrors veil piercing analysis from corporate law.
            ii. Courts analyze both
               1. "Separateness" factors; and
               2. "Alter ego" factors.

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[2] The official title includes "Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities."

[3] Statement of Financial Accounting Standards No. 140, ¶ 9 (Sept. 2000).

[4] The official title includes "Consolidation of Variable Interest Entities."

[5] These restrictions include when equity investors lack either (a) voting rights; or (b) the obligation to absorb expected losses; or (c) the rights to receive residual returns.

[6] FDIC v. Hogan (Matter of Gulfco Inv. Corp.), 593 F.2d 921, 928 (10th Cir. 1979).

b. Under another set of tests, courts balance benefits against harms of substantive consolidation.

ii. To mitigate bankruptcy risk, lawyers

1. Are sometimes asked to issue a "substantive non-consolidation opinion."

a. These are often accompanied by a "true sale opinion."

b. Both opinions are fact intensive and require analysis of corporate structures involved in transactions.

2. Changed structure of securitizations from "one-step" to "two-step" transactions.

iii. Lawyers were also involved in the creation of the "Expected Loss Note."

1. This is a security issued by a VIE and sold to an investor who essentially agrees to provide a "consolidation service."

2. The investor agrees to consolidate the VIE on its books to allow the sponsor of a VIE (often a bank sponsoring an asset-backed commercial paper facility) to avoid consolidation.

IV. PROBLEMS WITH CONSOLIDATION IN SECURITIZATIONS AT THE HEART OF THE CRISIS

a. Does non-consolidation impact investors or financial regulation?

i. Empirical data on firms, particularly financial institutions, using securitization to remove leverage from balance sheet.

ii. Empirical data on correlation between a financial institution's use of securitization and the institution's risk.

iii. Other empirical evidence of timing of securitization to improve financial statements

iv. Empirical data on correlation between off-balance sheet financing and misstatements.

v. To what extent does the market see through attempts to avoid consolidation? Empirical evidence.

b. Desire to avoid consolidation drove many subprime securitizations

i. Data on "balance sheet securitizations"

c. Gamesmanship posed by these consolidation rules representing an "all-or-nothing" determination.

i. Non-consolidation by lenders (originators) was permissible despite lender retaining valuable rights (particularly servicing rights) with respect to a securitization.

ii. Non-consolidation by investors (and some lenders) was permissible despite significant holdings of a particular SPE's asset-backed securities.

iii. Non-consolidation of VIEs (*e.g.*, Asset-Backed Commercial Paper Conduits) despite sponsor having "moral recourse," liquidity support or credit enhancement obligations.

d. Parallels between non-consolidation in the subprime crisis and the Enron era.

V. REFORMS DURING CRISIS TO CONSOLIDATION RULES MAY UNDERMINE BEDROCK PRINCIPLES

a. To facilitate crisis management, accounting bodies have re-interpreted several consolidation rules

i. For example, mortgage modifications would threaten to cause servicers to consolidate SPEs.

ii. This prompted new guidance on FAS 140.

b. Numerous proposals have been floated to require lenders to retain a portion of loans being securitized.

i. These proposals would address numerous problems with adverse selection and agency costs created by lenders securitizing loans.
ii. These proposals would require changing bankruptcy rules to prevent SPEs from becoming part of the lender's bankruptcy estate.

c. A tension is emerging between principles of accounting consolidation and addressing some of the flaws in securitization . . .
d. *But it is vital to preserve principles of accounting consolidation.*
e. There points to a need to revisit coupling and decoupling accounting standards from other legal standards with respect to consolidation
   i. Consider partially decoupling bankruptcy standards from consolidation standards.
      1. If bankruptcy law is amended to allow or require lenders to retain interests in loans being securitized, this should not trump lender's duty under accounting rules to consolidate.
   ii. Revisit coupling accounting consolidation with tax consolidation.

VI. SELECT SCHOLARLY IMPLICATIONS: THE NEED FOR *INTRA*-DISCIPLINARY TRANSACTIONAL SCHOLARSHIP

a. Consider whether abuses of non-consolidation are facilitated by
   i. The technical nature of accounting rules;
   ii. Deference to the accounting industry; and
   iii. The fact that accounting rules cut across business law specialties, leading to failure of lawyers and legal scholars in any one business field having sufficient perspective or incentive to address issues of consolidation.[7]
b. This argues for further integration in scholarship and teaching:
   i. Not only of accounting with various business law fields,
   ii. But also integration *among* business law fields, including business associations, securities law, bankruptcy and commercial law and financial institution regulation.
   iii. *Intra*-disciplinary scholarship is vital.
c. Transactional scholarship provides a vehicle for this *intra*-disciplinary integration that focuses on pressing problems in practice and regulation.
   i. This approach is important because it mirrors business law practice, as lawyers are required to solve client problems that seldom fit into doctrinal boxes.
   ii. In addition, accounting treatment, like tax considerations, shapes, and often drives, the structure of business transactions.

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[7] *Cf.* Lawrence A. Cunningham, *Sharing Accounting's Burden: Business Lawyers in Enron's Dark Shadows*, 57 BUS. LAW. 1421 (2002).