06-1080-CV

IN THE

United States Court of Appeals

FOR THE SECOND CIRCUIT

AON FINANCIAL PRODUCTS, a Delaware Corporation,
and AON CORPORATION, a Delaware Corporation

Plaintiffs-Appellees,

-against-

SOCIETE GENERALE, a French Banking Institution

Defendant-Appellant.

**ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK**

BRIEF OF *AMICUS CURIAE* IN SUPPORT OF THE BRIEF OF DEFENDANT-APPELLANT

CADWALADER, WICKERSHAM & TAFT LLP
One World Financial Center
New York, NY 10281
(212) 504-6000

*Attorneys for Amicus Curiae
International Swaps and
Derivatives Association, Inc.*

TABLE OF CONTENTS

PAGE

TABLE OF AUTHORITIES ii

PRELIMINARY STATEMENT 1

STATEMENT OF INTEREST 3

CREDIT DEFAULT SWAPS: AN OVERVIEW 7

A. Purpose 7

B. Documentation 8

C. Mechanics and Operation 10

ARGUMENT 11

I. THE PARTIES' ENTIRE AGREEMENT IS REFLECTED IN THE FOUR CORNERS OF THE SG CDS 11

II. SATISFACTION OF THE "CONDITIONS TO PAYMENT" TRIGGERS THE PARTIES' OBLIGATION TO SETTLE THE SWAP IN COMPLIANCE WITH THE SETTLEMENT TERMS 16

A. CDSs Require Compliance With Both The "Conditions To Payment" And "Settlement Terms" 16

B. Physical Settlement Requires Simultaneous Performance By The Parties 18

C. The Court Must Give Effect To "Deliverable Obligations" As Defined In The SG CDS 20

CONCLUSION 22

CERTIFICATE OF COMPLIANCE iv

TABLE OF AUTHORITIES

PAGE(S)

CASES:

Breed v. Insurance Co. of N. Am.,
385 N.E.2d 1280 (N.Y. 1978) 12-13

Cruden v. Bank of N.Y.,
957 F.2d 961 (2d Cir. 1992) 12

Eternity Global Master Fund Ltd. v. Morgan Guar. Trust Co. of N.Y.,
375 F.3d 168 (2d Cir. 2004) .... *passim*

Galli v. Metz,
973 F.2d 145 (2d Cir. 1992) 16

Grumman Allied Indus., Inc. v. Rohr Indus., Inc.,
748 F.2d 729 (2d Cir. 1984) 12

McAnarney v. Newark Fire Ins. Co.,
159 N.E. 902 (N.Y. 1928) 7

Monaghan v. SZS 33 Assocs., L.P.,
875 F. Supp. 1037 (S.D.N.Y. 1995), *aff'd*,
73 F.3d 1276 (2d Cir. 1996) 12-13

Muzak Corp. v. Hotel Taft Corp.,
133 N.E.2d 688 (N.Y. 1956) 16

Rainbow v. Swisher,
527 N.E.2d 258 (N.Y. 1988) 13-14

Seiden Assocs. v. ANC Holdings, Inc.,
959 F.2d 425 (2d Cir. 1992) 12-13

Ursa Minor Ltd. v. Aon Fin. Prods., Inc.,
No. 00Civ-2474, 2000 WL 1010278 (S.D.N.Y. July 21, 2000), *aff'd*,
7 Fed. Appx. 129 (2d Cir. 2001) (*per curiam*) 19

PAGE(S)

STATUTES & OTHER AUTHORITIES:

1-3 *Bender's N.Y. Ins. Law* § 3.03[1][e][xi] (2005) 7

1998 ISDA Confirmation of OTC Credit Swap Transaction 4, 17

1999 ISDA Credit Derivative Definitions 5

2003 ISDA Credit Derivative Definitions 11, 17

ISDA 2005 Year End Survey , http://www.isda.org/statistics/recent.html
(last visited May 8, 2006) 4

http://www.isda.org (follow "Education" hyperlink; then follow
"Derivatives Documentation" hyperlink) (last visited May 8, 2006)........... 5, 8-9

Basel Committee on Banking Supervision, The Joint Forum,
Credit Risk Transfer (Mar. 2005), http://www.bis.org/publ/joint13.htm
(last visited May 8, 2006) 6, 8, 11

B. Gerard Dages *et al.*, Federal Reserve Bank of New York,
An Overview of Emerging Market Credit Derivatives Market (May
2005), http://www.bis.org/publ/cgfs22fedny4.pdf (last visited May 8,
2006) 8

Remarks by Chairman Alan Greenspan to the Federal Reserve Bank
of Chicago's 41st Annual Conference on Bank Structure,
Risk Transfer and Financial Stability 4 (May 5, 2005),
http://www.federalreserve.gov/Boarddocs/Speeches/2005/20050505/
default.htm (last visited May 8, 2006)..4, 6

The International Swaps and Derivatives Association, Inc. ("ISDA") submits this *amicus* brief in support of the request of defendant-appellant Société Générale ("SG") to reverse: (1) the final judgment of the United States District Court for the Southern District of New York (Daniels, J.) (the "District Court") in favor of plaintiffs-appellees Aon Financial Products and Aon Corporation (collectively, "Aon") and against defendant-appellant in the amount of $10,128,917.42, entered on February 22, 2006; (2) Order of the District Court adopting the Report and Recommendations of Magistrate Judge Theodore H. Katz (the "Magistrate Judge") on January 19, 2006 awarding Aon attorneys fees, costs and interest, entered on February 23, 2006; (3) Judgment of the District Court denying SG's motion for judgment on the pleadings and granting Aon's motion for summary judgment, entered on March 4, 2005; and (4) Memorandum Opinion and Order of the District Court denying SG's motion for judgment on the pleadings and granting Aon's motion for summary judgment, entered on February 22, 2005. All parties have consented to the filing of this *amicus* brief. Moreover, ISDA incorporates by reference herein the Statement of the Case and the Statement of Facts contained in SG's brief.

PRELIMINARY STATEMENT

In 1999, SG and Aon entered into a credit default swap ("CDS") through which SG sold Aon credit protection on the risk of default by the Republic

of Philippines (the "SG CDS"). The SG CDS was based on standard ISDA documentation governed by New York law. When the dispute concerning SG's liability under the SG CDS was brought before it, the District Court and the Magistrate Judge violated fundamental principles of contract interpretation by reaching outside of the four corners of the clear and unambiguous SG CDS. Specifically, the District Court and the Magistrate Judge looked to another CDS to which SG was not a party and which contained different terms (the "BSIL CDS") – to ascertain Aon's and SG's intent in entering into the SG CDS. The lower court also ignored the plain language of the transaction settlement terms in holding that SG's obligation to pay was independent of Aon's compliance therewith. Finally, the lower court failed to use terms as defined in the SG CDS, and consequently rewrote the parties' agreement in rendering its decision.

The District Court's errors in this case are of such a fundamental nature that they cast significant doubt on the operation of credit default swap contracts. The rulings are directly contrary to the settlement mechanics set forth in ISDA's standard documentation that is used in this $17.1 trillion market. Even if the issue were waived, ISDA's interest in correcting the District Court's obvious misunderstanding of the mechanics and operation of credit default swaps remains. Indeed, if this decision is left to stand, it will result in a lack of confidence in credit default swaps and cause tremendous legal uncertainty. Moreover, the product's

importance as a credit risk mitigant, noted by the Board of Governors of the Federal Reserve System, the Federal Reserve Bank of New York, and the Bank for International Settlement, among others, would be undermined. Accordingly, the Judgments and Orders of the District Court should be reversed. Because of the importance of the issue to the market, ISDA also respectfully requests that this Court address CDS settlement mechanics in its written disposition of this appeal.

STATEMENT OF INTEREST

ISDA is the largest financial trade association in the world, representing leading participants in the privately negotiated derivatives industry. It was chartered in 1985, and comprises more than 700 member institutions from 46 countries on six continents. These members include most of the world's major institutions that deal in, and are leading end-users of, privately negotiated derivatives, as well as associated service providers and consultants. Since its inception, ISDA has fostered and enabled innovations in the derivatives business through its legal, documentation, netting, public policy, operations and risk management initiatives throughout the world. Among its most significant contributions is the standardization of derivatives documentation through the promulgation of ISDA Master Agreements and product-specific forms and definitions, including those at issue here. Today, ISDA Master Agreements serve

as the contractual foundation for more than 90% of derivatives transactions globally, including the CDS transaction at issue here.

As noted by Alan Greenspan, then-Chairman of the Board of Governors of the Federal Reserve System, "the most significant development in the financial markets over the past ten years has been the rapid development of credit derivatives." Remarks by Chairman Alan Greenspan to the Federal Reserve Bank of Chicago's 41st Annual Conference on Bank Structure, *Risk Transfer and Financial Stability* 4 (May 5, 2005), http://www.federalreserve.gov/Boarddocs/Speeches/2005/20050505/default.htm (last visited May 8, 2006). Indeed, from mid- to year-end 2005 alone, credit derivatives grew 38% from $12.4 trillion notional value to $17.1 trillion. *ISDA 2005 Year End Survey*, http://www.isda.org/statistics/recent.html (last visited May 8, 2006). This growth is attributable to "[a] liquid market [in credit derivatives]," which "did not emerge until [ISDA] succeeded in standardizing documentation of these transactions in 1999." Greenspan, *supra*, at 4. That standardization began in 1998 with ISDA's publication of a standard long-form confirmation for use in credit derivatives transactions. *See 1998 ISDA Confirmation of OTC Credit Swap Transaction*. ISDA then published the 1999 ISDA Credit Derivative Definitions, which represents "a comprehensive lexicon governing credit derivatives transactions." *Eternity Global Master Fund Ltd. v. Morgan Guar. Trust Co. of N.Y.*, 375 F.3d

168, 174 (2d Cir. 2004) (citations omitted). These definitions are a codification of industry custom, practice and usage developed in the credit derivative market through that time, and were intended for use in confirmations of individual credit derivative transactions ("Confirmations") governed by ISDA Master Agreements. *See* http://www.isda.org (follow "Education" hyperlink; then follow "Derivatives Documentation" hyperlink) (last visited May 8, 2006).[1]

This case involves the determination of the operation and mechanics of a CDS that is documented in a Confirmation based on ISDA's 1998 standard credit derivative form and was entered in or about the time that ISDA published its 1999 ISDA Credit Derivative Definitions. The Confirmation states that it is subject to the 1992 ISDA Master Agreement, which is still the predominant form of agreement in use by market participants today. The Confirmation further incorporates ISDA's 1991 Definitions as supplemented by the 1998 Supplement, which definitions were replicated in relevant part in the 1999 ISDA Credit Derivatives Definitions. Counterparties today may incorporate those (or subsequent) definitions into their CDS documentation.

---

[1] The 1999 ISDA Credit Derivative Definitions also contain a sample short-form transaction confirmation that reflects industry custom, practice and usage, and which has served as a model for documenting individual credit derivative transactions. *1999 ISDA Credit Derivative Definitions* at 37. ISDA also published the 2003 ISDA Credit Derivative Definitions. While those definitions are not at issue here, the market conventions reflected in them remain the same as those at issue here.

Regardless of which ISDA Master Agreement or definitions are incorporated into a Confirmation, the fundamental operation and mechanics of credit derivative transactions are the same. Moreover, virtually *every* credit derivative transaction entered into to date has been documented using ISDA documentation. *See* Greenspan, *supra*, at 4. Thus, ISDA is uniquely positioned to address the operation and mechanics of CDS transactions, including the one here, and has a substantial interest in ensuring that transactions that use ISDA standard form documents and definitions, including those at issue here, are enforced so as to promote legal certainty and hence, market stability. *See* Basel Committee on Banking Supervision, Joint Forum, *Credit Risk Transfer* 2 (Mar. 2005), http://www.bis.org/publ/joint13.htm (last visited May 8, 2006) ("Basel Joint Forum") (noting the importance of ISDA's industry-standard documentation to market participants' confidence in the legal status of CDSs).

Although ISDA's many members are from time-to-time involved in litigation, ISDA's involvement in litigation as *amicus curiae* is rare and is undertaken only to serve the overall interests of the ISDA membership and the derivatives market. In fact, this is the first case in which ISDA has offered an *amicus curiae* submission concerning the operation and mechanics of credit default swaps. This submission results from the conclusion of ISDA's Executive Director and Chief Executive Officer and its General Counsel that the issues presented in

this case are of major concern to all ISDA members and other market participants entering into credit default swaps using ISDA documentation and definitions.

CREDIT DEFAULT SWAPS: AN OVERVIEW

A. Purpose

As this Court has noted, "a credit default swap is a bilateral financial contract in which '[a] protection buyer makes[ ] periodic payments . . . to a protection seller, in return for a contingent payment if a predefined credit event occurs in the reference credit,' *i.e.*, the obligation on which the contract is written." *Eternity Global,* 375 F.3d at 172 (citation omitted). Protection buyers may use credit default swaps "to manage particular market exposures and return-on-investments," while protection sellers may use them "to earn income and diversify their own investment portfolios." *Id.*

CDSs do not, and are not meant to, indemnify the buyer of protection against loss.[2] Rather, CDSs allow parties to "hedge" risk by buying and selling risks at different prices and with varying degrees of correlation. Often, the credit

[2] Indemnity is an insurance concept. *See*, *e.g.*, *McAnarney v. Newark Fire Ins. Co.*, 159 N.E. 902, 904 (N.Y. 1928). CDSs are not insurance for numerous reasons. Most significantly, there is no requirement that the protection buyer own the asset on which it is buying protection or that it suffer any loss. 1-3 *Bender's N.Y. Ins. Law* § 3.03[1][e][xi] (2005). Other common features of CDSs that distinguish them from insurance include: (i) the absence of a requirement that the buyer provide proof of loss as a condition to payment; (ii) payment upon settlement that may be more than the loss (if any) suffered by the buyer; (iii) the absence of rights of subrogation; and (iv) differences in accounting, tax, bankruptcy and other regulatory treatment.

risk being hedged by a protection buyer is the very asset that must be delivered to the protection seller upon the occurrence of a stated credit event. In other instances, such as in emerging markets transactions, the protection buyer may calculate that a credit risk to which it is exposed "'is reasonably correlated with the performance of [the sovereign] itself,' so that . . . the [protection buyer] may seek to isolate and hedge country risk [by purchasing a CDS] written on some portion of the sovereign's outstanding debt." *Eternity Global,* 375 F.3d at 172 (citations omitted); *see also* B. Gerard Dages *et al.*, Federal Reserve Bank of New York, *An Overview of Emerging Market Credit Derivatives Market* (May 2005), http://www.bis.org/publ/cgfs22fedny4.pdf (last visited May 8, 2006). The protection buyer thus assumes the risk of how well-correlated the two defaults will be. That correlation of default is "the most important credit risk management issue associated with [credit default swaps]." Basel Joint Forum, *supra*, at 3.

B. <u>Documentation</u>

Counterparties to a credit derivatives transaction enter into a standard form ISDA Master Agreement, including the ISDA 1992 Master Agreement at issue here. *See generally* http://www.isda.org (follow "Education" hyperlink; then follow "Derivatives Documentation" hyperlink). ISDA Master Agreements govern the legal and credit relationship between the counterparties, including representations and warranties, events of default and termination, covenants and

choice of law (either New York, as here, or English). *Id.* Negotiated "Schedules" make counterparty-specific elections and changes to the standard provisions in the ISDA Master Agreements. *Id.*

"Confirmations" set forth the economic terms and transaction-specific modifications to the ISDA Master Agreement and Schedule, and indicate which set of ISDA definitions (if any) are applicable. Confirmations document the precise risk that the parties wish to transfer and price. As discussed *infra*, some of the key terms that the parties define in a CDS are "Credit Event," "Reference Entity," "Reference Obligation," "Obligation," and "Deliverable Obligation."[3]

Each confirmation evidences a complete and binding agreement between the contracting parties as to the terms of the particular transaction to which it relates. Indeed, the ISDA Master Agreement, to which each Confirmation is subject, contains an integration clause: "This agreement constitutes the entire agreement and understanding of the parties with respect to its subject matter and supercedes all oral communication and prior writings with respect thereto." *See, e.g.,* A-454 at ¶ 9(a).[4] Thus, each Confirmation must be enforced pursuant to its express terms. Documents not specifically incorporated by reference into a Confirmation are irrelevant to the risks transferred under the CDS.

---

[3] Capitalized terms are used generally in reference to standard ISDA documentation, unless specifically defined herein in reference to the SG CDS.

[4] The Joint Appendix is cited as "A-__."

C. **Mechanics and Operation**

There are three components to a CDS: (1) the occurrence of a stated "Credit Event;" (2) satisfaction of stated "Conditions to Payment" a/k/a "Conditions to Settlement;" and (3) settlement of the swap.

A specified "Credit Event" must occur before settlement obligations arise under a CDS. Whether a Credit Event has occurred must be made by reference to the events agreed to by the parties as specified in the Confirmation. That determination involves consideration of the performance of the "Reference Entity" with respect to its "Obligation," each as defined in the Confirmation.

Once a Credit Event occurs, the protection buyer must fulfill the "Conditions to Payment" as specified in the Confirmation to trigger the process of the swap's settlement. Those "Conditions to Payment" include a Notice of Credit Event, Notice of Publicly Available Information (to provide public confirmation of the Credit Event) and Notice of Physical Settlement.

Once a Credit Event occurs and the Conditions to Payment are satisfied, each party must perform its settlement obligations as specified in the CDS Confirmation. Settlement of a CDS may be through Physical Settlement or Cash Settlement, as specified in the Confirmation. Where Physical Settlement is specified, it must be on a "delivery versus payment" basis. It thus requires simultaneous, bilateral action: the buyer must tender a "Deliverable Obligation"

and the seller must pay the amount specified in the Confirmation.[5] A "Deliverable Obligation" may be a specifically-identified obligation or an obligation of a specific type ("Category") and having specific "Characteristics." In the latter case, the Confirmation will set forth the details of the Category and Characteristics that make an asset a "Deliverable Obligation" within the meaning of the parties' transaction.[6]

It is against this backdrop that the District Court's opinions, orders and judgments must be assessed.[7]

ARGUMENT

I. THE PARTIES' ENTIRE AGREEMENT IS REFLECTED IN THE FOUR CORNERS OF THE SG CDS

Legal certainty in the use of standardized ISDA documentation is a significant factor contributing to the rapid growth of the CDS market. *See* Basel Joint Forum, *supra*, at 2. In choosing New York law to govern their CDSs, market

---

[5] The CDS market expects simultaneous, contemporaneous "delivery versus payment" unless the market practice for the specific Deliverable Obligation requires otherwise. *See 2003 ISDA Credit Derivative Definitions* at 44 § 8.1.

[6] For purposes of defining certain Characteristics, the parties may also identify a "Reference Obligation" which has characteristics similar to those that a Deliverable Obligation must have. However, unless the Confirmation provides otherwise, this would not make the Reference Obligation the only Deliverable Obligation.

[7] ISDA does not comment upon the case-specific factual determinations made by the District Court and the Magistrate Judge, including whether a "Credit Event" occurred or whether SG waived the issue of settling the SG CDS.

participants reasonably expect that courts in this jurisdiction will effectuate their contractual intent as expressed within the four corners of each CDS. *See Cruden v. Bank of N.Y.*, 957 F.2d 961, 976 (2d Cir. 1992) ("Under New York law, a written contract is to be interpreted so as to give effect to the intention of the parties as expressed in the unequivocal language they have employed"). The lower court rulings undermine this expectation, and thus threaten the legal certainty inherent in standard ISDA documentation, by reaching outside the SG CDS to a separate contract *not involving SG* to find that "[t]he clear intent of the parties was that SG would guarantee payment to Aon and AFP on the condition that they became liable to BSIL upon the occurrence of a Credit Event." (A-669-70; A-897-98, 902, 907, 909, 911, 915-16).

CDSs are complex risk management tools negotiated by sophisticated counterparties who buy and sell credit risk. Their contractual relationships should not be disturbed where, as here, the terms of the contract are clear and unambiguous. *Grumman Allied Indus., Inc. v. Rohr Indus., Inc.*, 748 F.2d 729, 735 (2d Cir. 1984). "No ambiguity exists when a contract provision has definite and precise meaning, without danger of misconception as to the intended meaning of the agreement, and concerning which reasonable people would not disagree." *Monaghan v. SZS 33 Assocs., L.P.*, 875 F. Supp. 1037, 1043 (S.D.N.Y. 1995) (*citing Breed v. Insurance Co. of N. Am.*, 385 N.E.2d 1280, 1282-83 (N.Y. 1978);

Seiden Assocs., Inc. v. ANC Holdings, Inc., 959 F.2d 425, 428 (2d Cir. 1992)), *aff'd*, 73 F.3d 1276 (2d Cir. 1996).

The relevant language of the SG CDS is clear and unambiguous. Under the SG CDS, SG was selling credit risk protection on the "Reference Entity," unambiguously defined as the Republic of Philippines. (J-44 at 1). "Obligation" was clearly defined as, "[w]ith respect to the Reference Entity, any obligation, (whether future, contingent or otherwise, as principal or surety or otherwise) for the payment or repayment of money." (A-45 at 3). The clear intent of the parties was that upon the occurrence of a stated "Credit Event," each of which referred to the performance of the "Reference Entity" in relation to the "Obligations," Aon would tender a Deliverable Obligation, the Category and Characteristics of which were defined as "any bond obligations of the Reference Entity, [denominated in USD] . . . that rank equal in priority of payment to the Reference Obligation," which itself is a bond unambiguously identified by ISIN, maturity and reference amount. (A-44-47 at 1, 4). Absent ambiguity, resort to parole evidence in the form of the BSIL CDS was unwarranted. *See Seiden Assocs.*, 959 F.2d at 428 ("If the language unambiguously conveys the parties' intent, extrinsic evidence may not properly be received . . ."); *Rainbow v. Swisher*, 527 N.E.2d 258, 259 (N.Y. 1988) ("Where . . . the contract is clear and

unambiguous on its face, the intent of the parties must be gleaned from within the four corners of the instrument, and not from extrinsic evidence").

Tellingly, the Magistrate Judge noted that the terms of the SG CDS were markedly different from the BSIL CDS. For example, the SG CDS does not define the Deliverable Obligation as the Reference Obligation, as was the case in the BSIL CDS. Nor does it "reference the Surety Bond, the Government Service Insurance System ("GSIS"), or the BSIL/AFP swap agreement." (A-920 at n.14). But these differences do not render the SG CDS ambiguous, as the Magistrate Judge found.

To the contrary, the differences between the swaps and the fact that they do not cross-reference each other are intentional and critical to each of the parties to the separate transactions. Aon had exposure to GSIS, whose performance on the Surety Bond was believed by Aon to be statutorily guaranteed by Republic of Philippines. From a market perspective, Aon hedged that exposure either (i) by purchasing protection on an obligation of Republic of Philippines (*i.e.*, the specifically-identified government issued bond) that was different than the Republic's statutory guarantee, or (ii) by purchasing protection on a Reference Entity (Republic of Philippines) that was different than the Reference Entity on which it sold protection (GSIS) but whose default on a specific Reference Obligation (the government-issued bond) would be highly correlated to GSIS's

default on its Surety Bond. In either event, Aon's hedge was based on its assumption that one default was not likely to occur unless the other occurred. The accuracy of that assumption was a risk Aon bore, not SG.

The only commonality between the SG CDS and the BSIL CDS is that Aon is a party to both, as a buyer and seller of credit protection, respectively. Aon's role, however, cannot serve as a basis to collapse the two contracts into one. Indeed, to read the contracts together when they do not expressly reference one another would be to make market participants guarantors of their counterparty's risk correlation assumptions. That is not the purpose of CDSs. The District Court's finding that the SG CDS was one of indemnity was in error. (S*ee* A-669-70; A-902, 909, 911). If that finding is left to stand, it would have a chilling effect on the financial markets and would eliminate a significant means by which banks, financial institutions and corporations diversify their credit risks. Accordingly, the District Court's and Magistrate Judge's ruling that the parties entered into the SG CDS to hedge an independent credit risk that Aon had in its portfolio is in error and should be reversed.

II. SATISFACTION OF THE "CONDITIONS TO PAYMENT" TRIGGERS THE PARTIES' OBLIGATION TO SETTLE THE SWAP IN COMPLIANCE WITH THE SETTLEMENT TERMS

A. CDSs Require Compliance With Both The "Conditions To Payment" And "Settlement Terms"

A fundamental precept of contract interpretation under New York law is that each provision of a contract must be interpreted so as to be given effect. *See Galli v. Metz*, 973 F.2d 145, 149 (2d Cir. 1992); *Muzak Corp. v. Hotel Taft Corp.*, 133 N.E.2d 688, 690 (N.Y. 1956) (courts must "adopt an interpretation which gives meaning to every provision of a contract, or, in the negative, no provision of a contract should be left without force or effect"). In finding that the SG CDS "obligates Société Générale to pay AFP $10,000,000 upon receipt of a notice that a Credit Event had occurred," the District Court and Magistrate Judge violated this principle by failing to consider – much less give effect to – the "Settlement Terms" contained in this and every other CDS. (A-673; *see* A-668, 671; A-916-19; A-978).[8]

Upon fulfillment of the "Conditions to Payment" that trigger the swap, both parties to the CDS are obligated to settle the swap according to the

[8] The Magistrate Judge acknowledged that satisfaction of Conditions to Payment triggers a settlement process, and clearly set out the steps in that settlement process. (A-917-18). Rather than effectuate those steps, the Magistrate Judge dismissed them as being "difficult to discern." (A-918). The Magistrate Judge does not explain why they are "difficult to discern," especially since each of the terms used therein was clearly defined in the SG CDS Confirmation.

"Settlement Terms." This Court in *Eternity Global* expressly recognized the linked "trigger" and "settlement" components of a CDS:

> [I]n a credit default swap . . . [a "default" is] a stipulated bundle of "credit" events (such as bankruptcy, debt moratoria and debt restructurings) that will trigger the protection seller's obligation to "settle" the contract *via the swap mechanism agreed to by the parties*. . . . The occurrence of a credit event triggers the "swap," *i.e.*, the protection seller's obligation to pay on the contract *according to the settlement mechanism*.

375 F.3d at 172 (emphasis added; citations omitted).

Rather than acknowledge this controlling precedent, both the District Court and Magistrate Judge myopically focused on the section heading "Conditions to Payment" without considering its substantive text within the context of the entire agreement. The SG CDS, however, expressly cautions against doing so: "The headings used in th[e] Confirmation are for convenience of reference only and are not to affect the construction of or to be taken into consideration in interpreting th[e] Agreement." (A-41 at 6(e)).

When viewed in context of the entire agreement, it is clear that satisfaction of "Conditions to Payment" are in fact conditions precedent to settling the swap according to the Settlement Terms.[9] For example, "Physical Settlement"

[9] Indeed, the 2003 ISDA Credit Derivative Definitions and corresponding model Confirmation changed the "Conditions to Payment" heading to read "Conditions to Settlement." *Compare 1998 ISDA Confirmation of OTC Credit Swap Transaction* at 4 *with 2003 ISDA Credit Derivative Definitions* at 63.

itself states: "*If the Conditions to Payment have been satisfied*, Buyer shall Deliver to Seller the Portfolio and Seller shall pay to Buyer the Physical Settlement Amount on the Physical Settlement Date." (A-34 (emphasis added)). "Physical Settlement Date" is defined as 7 days *after* Conditions of Payment are met." (*Id.* (emphasis added)). Similarly, under Section 6(b)(ii)(A), "each party agree[d] with the other" that "*[s]ubject to the Conditions to Payment*, the parties will be obligated to comply with the Settlement Terms of this Transaction . . . ." (A-38 at 6(b)(ii)(A) (emphasis added). Thus, the SG CDS – as well as all other CDSs modeled after standard ISDA documentation – clearly and unambiguously requires the parties to satisfy both the "Conditions of Payment" and "Settlement Terms" to close out the swap. Any interpretation that fails to give effect to the Settlement Terms is squarely at odds with New York law and the economics and risks agreed to by the parties.

B. Physical Settlement Requires Simultaneous Performance By The Parties

While the Magistrate Judge correctly concluded that Aon's tender of a Deliverable Obligation was not a "Condition to Payment" triggering the swap, he erred in holding that its tender was irrelevant to, and independent of, SG's obligation to make payment to Aon. (A-918-19). The clear and unambiguous language of the SG CDS mandates "delivery versus payment," *i.e.*, simultaneous performance, by the parties once physical settlement of the swap is triggered:

> If the Conditions to Payment have been satisfied, Buyer shall Deliver to Seller the Portfolio and Seller shall pay to Buyer the Physical Settlement Amount on the Physical Settlement Date. *For the purpose of the foregoing, any Delivery under this provision shall be made on a delivery versus payment basis.*

(A-34 at 4 (emphasis added)).

This Court too has acknowledged that physical settlement under standard ISDA documentation requires simultaneous performance by the parties. *See Eternity Global*, 375 F.3d at 172-73, 174 ("'The contingent payment can be based on . . . physical delivery of the reference asset, *in exchange for* a cash payment equal to the initial notional (*i.e.*, face) amount [of the CDS contract]'") (citations omitted; emphasis added); *see also Ursa Minor Ltd. v. Aon Fin. Prods., Inc.*, No. 00Civ-2474, 2000 WL 1010278, at *8 (S.D.N.Y. July 21, 2000) ("*delivery . . . shall be made against payment* of AFP after the conditions to such payment have been satisfied") (emphasis added), *aff'd*, 7 Fed. Appx. 129 (2d Cir. 2001) (*per curiam*).

Failure to recognize and enforce the clear and unambiguous bilateral obligations under the SG CDS is contrary to market practice and will significantly undermine stability in the CDS market. Indeed, simultaneous exchange is the mechanism through which the contracted-for risk is transferred: the credit protection buyer receives payment equal to the par amount (*i.e.*, face value) of the asset and the credit protection seller receives a defaulted, below-market asset on

which it may pursue recovery. The difference in market value between the two represents the magnitude of loss that formed the basis for the seller's price for protection. To require SG to pay regardless of Aon's fulfilling its obligations to tender rewrites the parties' contract and fails to effectuate the economics underlying the CDSs.

C. The Court Must Give Effect To "Deliverable Obligations" As Defined In The SG CDS

Finally, the District Court and the Magistrate Judge erred by ignoring wholesale the definitions applicable to physical settlement that are contained in the SG CDS. Specifically, the Magistrate Judge found that the Surety Bond issued by GSIS qualifies as a Deliverable Obligation under the SG CDS because the District Court held that it was the only "reference obligation" that was issued. [*See* A-908, 920; A-676)

The SG CDS defines "Deliverable Obligation" by Category and Characteristic: "Any bond obligations of the Reference Entity [*i.e.*, Republic of Philippines], either directly or in its capacity as an unconditional guarantor, that rank equal in priority of payment with the Reference Obligation and are denominated in USD." (A-46). The "Reference Obligation" is defined as Republic of Philippines bonds in the amount of $500,000,000 maturing on April 15, 2008, with a coupon of 8.8750%, bearing a specified ISIN number. (A-45). The relevant inquiry is not whether the Surety Bond is the "Reference Obligation,"

as it clearly is not. Rather, the plain and unambiguous language of the SG CDS requires the District Court to determine whether the Surety Bond meets the Category and Characteristics of "Deliverable Obligation" as defined. The District Court failed to undertake that analysis.

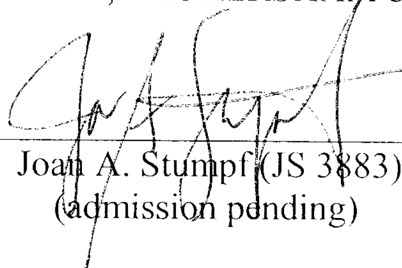
ISDA and the CDS market have an interest in ensuring that the stated Category and Characteristics of a Deliverable Obligation are recognized and enforced as written. Delivery of a different asset – or no delivery at all – fundamentally changes the magnitude of the risk assumed by the seller and therefore the price it would have charged the buyer for protection. Because the District Court failed to analyze whether the Surety Bond was a "Deliverable Obligation" as defined, it committed reversible error.

CONCLUSION

For the foregoing reasons, *amicus curiae* the International Swaps and Derivatives Association, Inc. respectfully requests that this Court reverse the Judgments and Orders of the District Court specified hereinabove.

Dated: New York, New York
May 8, 2006

CADWALADER, WICKERSHAM & TAFT LLP



Joan A. Stumpf (JS 3883)
(admission pending)

One World Financial Center
New York, New York 10281
(212) 504-6000

Attorneys for Amicus Curiae
International Swaps and Derivatives Association, Inc.

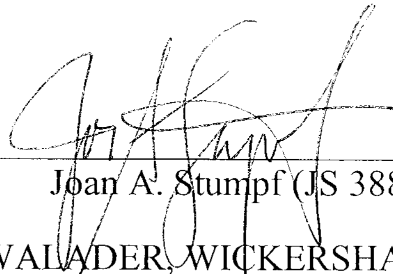
Of Counsel:
Lary Stromfeld

CERTIFICATE OF COMPLIANCE WITH TYPE-VOLUME LIMITATION, TYPEFACE REQUIREMENTS, AND TYPE STYLE REQUIREMENTS

1. This brief complies with the type-volume limitation of Fed. R. App. P. 32(a)(7)(B)(ii) because it contains 4885 words according to the word count of the word processing system used to prepare the brief, excluding the parts of the brief exempted by Fed. R. App. P. 32(a)(7)(B)(iii).

2. This brief complies with the typeface requirements of Fed. R. App. P. 32(a)(5) and the type style requirements of Fed. R. App. P. 32(a)(6) because it has been prepared in a proportionally spaced typeface using Microsoft Word 2002 in 14-point Times New Roman.

Dated: New York, New York
May 8, 2006



Joan A. Stumpf (JS 3883)
CADWALADER, WICKERSHAM & TAFT LLP
One World Financial Center
New York, New York 10281
(212) 504-6000