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03-9049(L)

03-9096(XAP)

IN THE

United States Court of Appeals

FOR THE SECOND CIRCUIT

SOMPONG SUCHARITKUL, DR.,

Special Master.

FINANCE ONE PUBLIC COMPANY LIMITED,

Plaintiff-Appellee-Cross-Appellant,

—against—

LEHMAN BROTHERS SPECIAL FINANCING, INC.,

Defendant-Appellant-Cross-Appellee.

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

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

Michael S. Feldberg
Joshua D. Cohn
ALLEN & OVERY LLP
1221 Avenue of the Americas
New York, NY 10020
(212)-610-6300

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

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MISCELLANEOUS

The International Swaps and Derivatives Association, Inc. ("ISDA") submits this amicus brief in support of the request of defendant-appellant/cross-appellee Lehman Brothers Special Financing, Inc. ("LBSF") to reverse the judgment of the United States District Court for the Southern District of New York (Motley, J.) (the "District Court") entered on September 8, 2003 (the "Judgment"), in particular in respect of the District Court's calculation of pre- and post- judgment interest.

STATEMENT OF INTEREST

ISDA is a not-for-profit corporation and the global trade association representing leading participants in the privately negotiated derivatives industry, a business which includes interest rate, currency, commodity, credit and equity swaps, as well as related products such as caps, collars, floors and swaptions. ISDA was chartered in 1985, and today numbers over 600 member institutions from 46 countries on six continents. (SPA-2 ¶ 4.) These members include most of the world's major institutions that deal in and leading end-users of privately negotiated derivatives, as well as associated service providers and consultants. (Dealers account for only approximately 200 of ISDA's more than 600 members.) Since its inception, ISDA has pioneered efforts to provide standard documentation for derivatives in order to reduce the sources of risk in the derivatives and risk management business for both its dealer and non-dealer members.

The ISDA Master Agreement (Multicurrency–Cross Border) (as published and copyrighted by ISDA in 1992, the "ISDA Master") is a standard form of agreement entered into by parties that wish to enter into one or more derivatives transactions with each other. Parties that have entered into an ISDA Master may then enter into derivatives transactions over time, each transaction being governed by and becoming a part of the relevant ISDA Master. It has been estimated that there are many tens of thousands of executed ISDA Masters in place (SPA-3 ¶ 7.) now governing many trillions of dollars of notional amount[1] of transactions, see ISDA 2003 Year-End Market Survey, available at www.isda.org. (ISDA Masters do not expire unless affirmatively replaced or terminated. Although ISDA has recently published a revised version of its master agreement, it is certain that the 1992 version at issue in this case will continue to govern a similarly large transaction volume for many years to come.) (SPA-3 ¶ 7.)

This case involves the determination of an interest amount payable upon early termination pursuant to the ISDA Master. The interest amount, as in the case at bar, may be a very significant sum, and miscalculation may produce a materially inequitable result. Most importantly, however, a precedent for such miscalculation may cause derivatives market participants to lose confidence in their ability to pursue their rights under the ISDA Master and applicable law,

[1] The notional amount is the theoretical value or quantity that is assigned to a derivatives transaction and on which the calculation of payments or delivery amounts is based.

producing risk and uncertainty in the derivatives markets. The ISDA Master is one of ISDA's primary achievements. ISDA has a substantial interest in ensuring that the ISDA Master (which makes no distinction between parties that are dealers or non-dealers, ISDA members or non-ISDA members) is properly applied in a manner that encourages sound risk management practices and market stability for the benefit of all market participants. As the ISDA Master's publishing association, ISDA is especially suited to offer guidance as to the proper interpretation of the provisions at issue here. To serve the Court, ISDA has brought to bear the skills of its own expert staff and enlisted expert counsel. Daniel Cunningham, partner at Allen & Overy LLP, has been ISDA's principal outside counsel for documentation matters since ISDA's organization in 1985. He was principal drafting counsel for the ISDA Master. (SPA-1-SPA-2 ¶ 3.) Joshua Cohn, partner at Allen & Overy LLP, was general counsel of an ISDA member institution in 1992 and involved as such in preparation of the ISDA Master. (SPA-6 ¶ 2.) One of Mr. Cohn's publications on the ISDA Master was quoted by the District Court in one of its opinions in the instant case (see Finance One Public Co. Ltd. v. Lehman Bros. Special Financing, Inc., 215 F.Supp.2d 397, 400 (S.D.N.Y. 2002). (SPA-6 ¶ 3.)

Although ISDA's many members are from time to time involved in litigation, ISDA's involvement in litigation as an *amicus curiae* is rare and is

undertaken only to serve the overall interests of the ISDA membership and the OTC markets. (SPA-2-SPA-3 ¶ 5.) In fact, this is the first case in which ISDA has offered an *amicus curiae* submission concerning the terms of the ISDA Master. 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 trading under ISDA Masters. (SPA-2-SPA-3 ¶¶ 5,6.)

PRELIMINARY STATEMENT

ISDA is the publisher of the ISDA Master, a form document in use throughout the world in the "over-the-counter," or privately negotiated, derivatives markets. The ISDA Master, which was drafted for ISDA by its counsel, as directed by its members, provides a comprehensive form of agreement that may be used by counterparties to govern all of the over-the-counter derivatives transactions between them from inception to termination. The ISDA Master offers uniform terms with respect to, among other things, the mechanics of termination, including the calculation of a termination payment and any interest thereon.

LBSF and Finance One Public Company Limited ("Fin One") entered into an ISDA Master dated June 30, 1995 and derivatives transactions thereunder in the course of 1995 and 1996. Finance One Public Co. Ltd., 215 F. Supp.2d at 397. On July 25, 1997, after Fin One had become insolvent, LBSF informed Fin

One that it was terminating the derivatives transactions, which Fin One agrees that LBSF was entitled to do under the parties' ISDA Master. Id. at 398, 400. On July 29, 1997, LBSF informed Fin One that it had calculated an aggregate Settlement Amount (as defined in the ISDA Master, essentially the value of the transactions to one party or the other) of approximately $9.7 million owing to Fin One. LBSF simultaneously and in the same letter asserted a set-off with respect to the Settlement Amount, producing a net amount of approximately $12,000 payable to Fin One (which we understand was paid by LBSF). Id. at 398-99.

Three years later, Fin One filed a lawsuit against LBSF, challenging LBSF's set-off. Id. at 399. Ultimately, after determining that Thai law controlled the issue of set-off and appointing a Special Master in Thai law who offered alternative approaches to set-off, the District Court ruled that LBSF was entitled to a set-off of approximately $4.3 million, roughly 45% of the set-off that LBSF had claimed initially. Finance One Public Co. Ltd. v. Lehman Bros. Special Financing, Inc., No. 00 Civ. 6739 (CBM), 2003 WL 2006598, at *2 (S.D.N.Y. May 1, 2003). Subsequent to that ruling, the District Court determined that, pursuant to the ISDA Master, LBSF owed Fin One approximately six years' interest on approximately $5.4 million of disallowed set-off at the Default Rate (this term and all other capitalized terms not otherwise defined have the meanings set forth in the ISDA Master). The District Court determined that the Default Rate in this case was to be

in the 17% to 18% range, based on a Thai baht interest rate incurred by Fin One in 1997.

The early termination provisions of the ISDA Master were carefully designed to assure parties appropriate notice of amounts payable. The ISDA Master reflects precise and deliberate distinctions in offering a choice of three different interest rates to be applied to amounts payable based on both the existence (or not) of notice of the amounts payable and the relative equities of the parties in causing early termination. The ISDA Master also specifies the currency in which amounts (including interest amounts) relating to early termination are to be paid.

The Judgment, unfortunately, does not correctly reflect either the language or the intent of the ISDA Master. ISDA urges this Court to reverse the Judgment, both to achieve a correct and fair result in the instant case and to avoid creating a dangerous precedent that will distort future practice in calculating interest amounts and chill future efforts of over-the-counter market participants to fully pursue their legitimate and important set-off rights.

ARGUMENT

I. THE NON-DEFAULT RATE OR THE TERMINATION RATE, NOT THE DEFAULT RATE, SHOULD BE APPLIED.

A. The Default Rate Applies Only to Obligations of a Defaulting Party or Obligations to Pay a Past Due Termination Payment pursuant to Section 6(e) of the ISDA Master.

Section 6(d)(ii) of the ISDA Master and related defined terms control the calculation of interest in this case. See Finance One Public Co. Ltd. v. Lehman Bros. Special Financing, Inc., No. 00 Civ. 6739 (CBM), 2003 WL 21638214 at *2 (S.D.N.Y. July 11, 2003). Section 6(d)(ii) provides that:

> [a]n *amount calculated as being due* in respect of any Early Termination Date *under Section 6(e)* will be payable on the day that *notice of the amount payable is effective* (in the case of an Early Termination Date which is designated or occurs as a result of an Event of Default) and *on the day which is two Local Business Days after the day on which notice of the amount payable is effective* (in the case of an Early Termination Date which is designated as a result of a Termination Event). Such amount will be paid together with (to the extent permitted under applicable law) *interest* thereon (before as well as after judgment) *in the Termination Currency*, from (and including) the relevant Early Termination Date to (but excluding) the date such amount is paid, at the Applicable Rate.

The definition of Applicable Rate referenced in Section 6(d)(ii) offers three possible rates: the Default Rate (based on the payee's cost of funds), the Non-Default Rate (based on the Non-Defaulting Party's cost of funds) and the Termination Rate (based on both parties' cost of funds). The District Court deemed the Default Rate to be applicable to LBSF's payment obligation. Id. at *2.

According to the definition of Applicable Rate, however, the Default Rate may apply in only two cases: (1) to the obligations of a Defaulting Party (a party as to which there exists an Event of Default) or (2) to a party that has failed to timely pay an amount payable pursuant to section 6(e). Neither of these cases is applicable to LBSF.

B. LBSF Is Not a Defaulting Party.

The record is devoid of facts that would allow characterization of LBSF as a Defaulting Party at the time it terminated its relationship with Fin One. Nor did LBSF become a Defaulting Party after that time. A failure to pay is an Event of Default under Section 5(a)(i) of the ISDA Master only if the payment in question was not paid "when due" and three local business days have passed "after notice of such failure is given to the party". In the case at hand, the record indicates that a specific amount payable by LBSF was calculated as due under the terms of the ISDA Master, if at all, only quite recently (see discussion of Section 6(d) of the ISDA Master below). It further appears that notice of any failure to pay still has not been given to LBSF in a manner that complies with the terms of the ISDA Master.

C. LBSF Did Not Fail to Pay a Past Due Amount pursuant to Section 6(e) of the ISDA Master.

The Default Rate may also apply to any party that has failed "to pay an amount under Section 6(e) . . . from and after the date (determined in

accordance with Section 6(d)(ii)) on which that amount is payable." *As described in Section 6(d)(ii) set forth above, the date of effectiveness of notice of the amount payable pursuant to Section 6(e) is key to determining the date such amount is payable.* It appears that no such notice was given by Fin One.

Section 6(e) provides for calculation of a payment on early termination by calculation of an aggregate Settlement Amount, followed by *application of any rights of set-off in determining the amount ultimately due.* Sections 6(d)(i) and 6(d)(ii) of the ISDA Master formalize the requirement to deliver a notice with respect to calculation of the amount due under Section 6(e). Section 12(a) of the ISDA Master makes it clear that any notice pursuant to Section 6 must be given by the most reliable and verifiable means to the address specified by the parties in the Schedule to their ISDA Master. The obvious goal of these provisions is to instill high procedural standards in the early termination process, so as to ensure clarity and certainty as to the parties' obligations.

We are aware of no notice given by Fin One in this case that would fulfill the requirements of the ISDA Master. LBSF's July 29, 1997 letter to Fin One appears to comply with the relevant sections of the ISDA Master, reporting, as it did, an aggregate Settlement Amount, a set-off and a payable of $12,305.27. This payable, however, is completely different from the payable later determined by the District Court after several years of litigation. The payable computed by

LBSF was based on the good faith assertion of a set-off right ultimately upheld in significant part by the District Court. (The District Court's August 2, 2002 judgment dismissed a claim that LBSF breached an obligation of good faith and fair dealing, see Finance One Public Co. Ltd., 215 F.Supp.2d at 403, and ultimately held that a set-off right did exist, see Finance One Public Co. Ltd., No. 00 Civ. 6739 (CBM), 2003 WL 2006598, at *2.) *In short, in this case it appears that Fin One never has given notice in compliance with the ISDA Master of the amount retrospectively determined by the District Court to have been payable by LBSF which is a prerequisite to triggering the application of the Default Rate to LBSF.* Furthermore, there appears to have been absolutely no way for LBSF to establish what, if anything, it might owe beyond the $12,305.27 it initially paid until the District Court's judgment regarding the amount of set-off was filed on May 1, 2003.

Assuming the Default Rate does not apply, choice of the appropriate Applicable Rate hinges on establishing whether termination is attributable to an Event of Default (a fault-based termination) or a Termination Event (a "no-fault" termination). In the former case, the Non-Default Rate would apply. In the latter case, the Termination Rate would apply. This choice of rates is required by the express terms of the ISDA Master and will result in an equitably correct outcome.

II. EQUITY AND SOUND MARKET POLICY PRECLUDE APPLICATION OF THE DEFAULT RATE.

A. The Equitable Basis of Interest Rate Selection.

The definition of Applicable Rate is intended to reflect the equities of the several situations it articulates. The Default Rate is most onerous to the payer. It reflects the payee's cost of funds plus 1% per annum. The Default Rate is intended to apply to a party that has caused a default termination (i.e., is blameworthy) or a party that has failed to heed a properly delivered termination payment notice. The Non-Default Rate, to be paid by a Non-Defaulting Party, simply reflects that party's own cost of funds with no additional spread. It effectively reflects any funding cost that the Non-Defaulting Party may have saved by retaining the underlying amount during the appropriate interest accrual period and causes the saved cost to be paid to the other party. The Termination Rate applies in all cases in which Default Rate and Non-Default Rate do not apply, including in the case of accrual of interest pending timely payment following a termination due to a Termination Event (often a "no-fault" termination). The Termination Rate is based on the arithmetic mean of each party's cost of funds and is intended to fit the "no-fault" character of the termination itself.

As stated above, LBSF is not a Defaulting Party and has not failed to heed a payment notice that complies with the ISDA Master. There is no

contractual or equitable foundation for causing LBSF to pay interest at the Default Rate.

B. The Equitable and Prudential Basis of Set-Off pursuant to Section 6(e) of the ISDA Master.

Consider the precedential effect of imposing the Default Rate on LBSF. Every time an ISDA Master terminates early, the parties (typically one of the parties) must calculate and give notice of payment due. An error in calculation of a payment due should not be punished by the levy of an onerous interest rate in any case where (as in the instant case) a party acting in good faith has based its calculation on the important right to set-off (in this case ultimately affirmed in significant part by the District Court).

The law of set-off, particularly across jurisdictional lines, can be complicated, but the proposition underlying set-off, that a party should not be obliged to pay another party that is withholding payment to it, is fundamentally simple and equitable. The ISDA Master specifically takes account of the possibility of set-off because the ISDA Master *provides an unusual elective mechanism for payment of an amount on early termination to a Defaulting Party* (or an Affected Party in a Termination Event) when the market value of the terminated transactions runs in favor of the Defaulting Party or Affected Party. See Sections 6(e)(i)(3) and (4). The ISDA membership chose to provide this elective mechanism in the ISDA Master in recognition of the perceived equities of

not depriving a Defaulting Party or Affected Party of the value of its transactions. The ISDA membership, however, recognized that the equities would be instantly reversed if a party were obliged to pay a Defaulting Party or Affected Party that was withholding funds from it. Accordingly, the ISDA Master specifically contemplates the possibility of set-off. See ISDA, User's Guide to the 1992 ISDA Master Agreements 1993 Edition 24 and 54-60 (1993). In summary, to apply the interest rate applicable to a Defaulting Party to LBSF in this case is not consistent with the express provisions of the ISDA Master, offends the basic equities underlying the terms of the ISDA Master and creates additional and unwarranted risks for parties attempting to exercise their rights under the ISDA Master and applicable law.

III. THE APPLICABLE RATE SHOULD BE BASED ON INTEREST RATES THAT ARE RELEVANT TO THE TERMINATION CURRENCY - U.S. DOLLARS.

As discussed above, we believe that the Default Rate should not be applied to the amount payable by LBSF. Regardless of which Applicable Rate option does apply, however, we believe that the Applicable Rate in this case should be based on U.S. dollar interest rates.

Section 6(d)(ii) of the ISDA Master requires that the amount payable in respect of any Early Termination Date under Section 6(e) must be paid together with interest thereon in the Termination Currency. (The Termination Currency is

defined to be as specified in the Schedule to the ISDA Master, in this case, effectively, U.S. dollars). It is important to note that the ISDA Master provides with great care that the Termination Currency requirement applies to each element of a possible early termination calculation. See Section 6(e)(i) and the definitions of "Settlement Amount" and "Loss". Section 6(d)(ii) completes this process by expressly applying this requirement to the interest calculation. This reflects the fact that choice of currency of payment is vitally important to those in the privately negotiated derivatives markets. See, e.g., Section 8(a) (Payment in the Contractual Currency).

That funding in different currencies is available at markedly different interest rates is of course obvious. In essence, to apply an interest rate available with respect to one currency to an underlying payable in another currency is an economic *non sequitur*.

The record indicates that the District Court has relied on Thai baht borrowing rates for the interest rate it has applied to LBSF. See Finance One Public Co. Ltd., No. 00 Civ. 6739 (CBM), 2003 WL 21638214 at *2 and the various Mongkhon Affidavits cited therein. Although we understand Thai baht rates to be the only actually incurred rates presented to the District Court by Fin One, we also note that each of the three rate options under the ISDA Master

provides that *the rates utilized need not have been actually incurred, and could therefore be determined on an extrapolated or synthetic basis.*

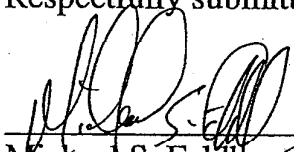
Accordingly, we urge this Court to reverse the District Court's decision to use rates that are contrary both to the express terms of the ISDA Master and basic economic logic in calculating any interest due.

CONCLUSION

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

Dated: New York, New York
May 19, 2004

Respectfully submitted,

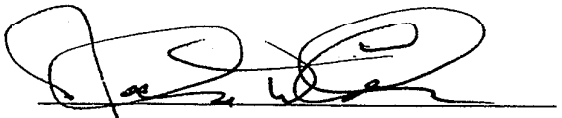


Michael S. Feldberg (MF 3974)
Allen & Overy LLP
1221 Avenue of the Americas
New York, NY 10020
(212)-610-6300

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

CERTIFICATE OF COMPLIANCE

I, Joshua D. Cohn, an attorney for the International Swaps and Derivatives Association, Inc., hereby certify that the foregoing brief complies with the type-face and volume limitations set forth in Federal Rule of Appellate Procedure 29(d) and Federal Rule of Appellate Procedure 32(a)(7). The total number of words in the foregoing brief is 3,507.



Joshua D. Cohn

CERTIFICATE OF SERVICE

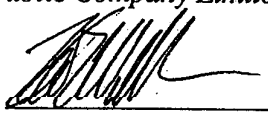
The undersigned hereby certifies that, on May 19, 2004, two copies of the Brief *Amicus Curiae* of the International Swaps and Derivatives Association, Inc. were served by hand delivery upon the following attorneys of record for plaintiff-appellee/cross-appellant and defendant-apellant/cross-appellee:

Jeffrey Q. Smith, Esq.
Scott E. Eckas, Esq.
King & Spalding LLP
1185 Avenue of the Americas
New York, New York 10036

Attorneys for Appellant
Lehman Brothers Special Financing, Inc.

Aaron Rubinstein, Esq.
Michael Pomerantz, Esq.
Kaye Scholer LLP
425 Park Avenue
New York, New York 10022

Attorneys for Appellee
Finance One Public Company Limited



Kurt R. Vellek

SPECIAL APPENDIX

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UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

FINANCE ONE PUBLIC COMPANY LIMITED, Plaintiff-Appellee-Cross-Appellant, -against- LEHMAN BROTHERS SPECIAL FINANCING, INC., Defendant-Appellant-Cross-Appellee.	No. 03-9049(L) On Appeal from the United States District Court for the Southern District of New York Index No.: 00-CIV-6739(CBM)

AFFIRMATION OF ROBERT G. PICKEL

I, ROBERT G. PICKEL, affirm under penalty of perjury under the laws of the United States as follows:

1. I submit this affirmation in support of the International Swaps and Derivatives Association Inc.'s Motion for Leave to File a Brief *Amicus Curiae* and in support of the International Swaps and Derivatives Association Inc.'s brief *amicus curiae* in support of the Brief of Defendant-Appellant-Cross-Appellee, filed on May 10, 2004 by defendant-appellant/cross-appellee Lehman Brothers Special Financing, Inc. ("LBSF"), requesting a reversal of the judgment of the United States District Court for the Southern District of New York.

2. I am Executive Director and Chief Executive Officer of the International Swaps and Derivatives Association, Inc. ("ISDA").

3. Daniel Cunningham, a partner at Allen & Overy LLP, has been ISDA's principal outside counsel for documentation matters since 1985. He was principal drafting

counsel of the 1992 ISDA Master Agreement (the "ISDA Master").

4. ISDA is a not-for-profit corporation. ISDA has more than 600 members distributed through 46 countries on six continents. Present dealer members include, among others, Bank of China (a state-owned bank), Hydro-Quebec (a major producer, transmission provider and distributor of electricity) and American International Group, Inc. (an insurance and financial services organization). Present non-dealer members include, among others, the Kingdom of Sweden, various Federal Home Loan Banks, McDonald's Corporation and numerous law firms. A complete ISDA membership list is available at www.isda.org.

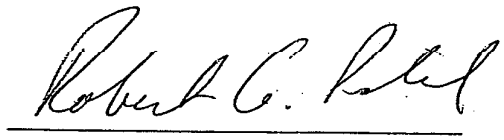
5. ISDA receives at least several requests a year from its members or others to submit *amicus* papers in litigation. ISDA's policy is to do so only when an issue of central importance to its membership and the over the counter derivatives markets is present. ISDA has never previously appeared as *amicus curiae* in relation to a question of interpretation of the ISDA Master. In fact, ISDA has appeared as *amicus curiae* in only three prior U.S. litigations, Cary Oil Co., Inc. v. MG Refining & Marketing, 257 F. Supp.2d 768 (S.D.N.Y. 2003), Bank One Corporation, et al., v. Commissioner of Internal Revenue, 120 T.C. 174 (2003) and In re Enron Corp., et. al. 306 B.R. 465 (Bankr. S.D.N.Y. 2004). Cary Oil involved a general question of retrospective application of a statutory provision. No ISDA members were litigants in that case. Bank One involved tax accounting issues generally relevant to ISDA members. An affiliate of an ISDA member was a litigant. Enron involved the scope of certain Bankruptcy Code provisions applicable to swaps and other transactions. In Enron, a broad cross-section of the

financial markets, including both ISDA members and non-ISDA members, was involved.

6. Kimberly Summe, General Counsel of ISDA, and I were the only persons to consider on behalf of ISDA, and to approve, ISDA's participation as *amicus curiae* before this Court.

7. In a recent survey of a relatively small group of dealer members, ISDA found tens of thousands of executed 1992 ISDA Master Agreements (ISDA Masters) in place. It seems quite safe to assume that the total number of such executed ISDA Masters in the entire over the counter derivatives markets is much greater. ISDA Masters do not expire. They will remain in place governing trades between the parties until superseded or affirmatively terminated. Although ISDA recently published its 2002 Master Agreement, early indications from the ISDA membership are that it will be many years before existing ISDA Masters are superseded.

Dated: May 14, 2004
New York, New York



Robert G. Pickel

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

FINANCE ONE PUBLIC COMPANY LIMITED, Plaintiff-Appellee-Cross-Appellant, -against- LEHMAN BROTHERS SPECIAL FINANCING, INC., Defendant-Appellant-Cross-Appellee.	No. 03-9049(L) On Appeal from the United States District Court for the Southern District of New York Index No.: 00-CIV-6739(CBM)

AFFIRMATION OF JOSHUA D. COHN

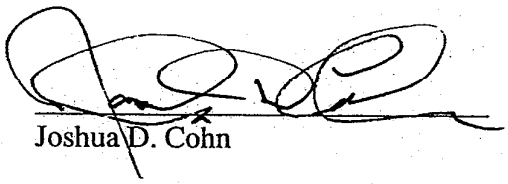
I, JOSHUA D. COHN, affirm under penalty of perjury under the laws of the United States as follows:

1. I am a partner at Allen & Overy LLP, counsel to the International Swaps and Derivatives Association, Inc. ("ISDA").

2. In 1992, I was general counsel of an ISDA member company and I was a participant in the committee of ISDA members responsible for developing the 1992 ISDA Master Agreement. I have been involved in the development of ISDA documentation since 1987.

3. I am the author of "ISDA Master Agreements: 1992 and 1987 Version's Described and Compared", which has been published numerous times by the Practicing Law Institute.

Dated: May 19, 2004
New York, New York



Joshua D. Cohn