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For the attention of: Kimberly Summe, General Counsel

Our ref EHM/30047-00700 ICM:3814434.5

20 December 2006

Dears Sirs

Close-out netting under English law

We refer to your letter of 11 September 2005 which refers to our Memorandum of law of 5 March 2004, as updated by our letters dated 15 November 2004 and 6 December 2005, regarding the enforceability of the termination, bilateral close-out netting and multibranch netting provisions of the 1987,¹ 1992 and 2002 ISDA Master Agreements (the **Memorandum**). Capitalised terms used in this letter without definition have, unless the context indicates otherwise, the meanings given to those terms in the relevant ISDA Master Agreements.

You have asked us to review any and all recent developments since 6 December 2005 that could materially and adversely affect the conclusions set out in the Memorandum. You have also asked us to inform you of any pending legal or regulatory developments in England and Wales concerning the enforceability of close-out netting.

We deal with each of these issues in turn below.

In addition, you have asked us to provide this update by reference to the list of Transactions which are set out in Appendix A to your letter of 11 September 2006, a copy of which (Appendix A only) is attached to this letter. Accordingly, the Memorandum, as updated by this letter, should be read as if the attached Appendix A had replaced the previous version of Appendix A attached to and referred to in the Memorandum.

1. RECENT DEVELOPMENTS

We confirm that since 6 December 2005 there have not been any developments that could materially and adversely affect the conclusions set out in the Memorandum. The advice given in the

¹ The ISDA Interest Rate Swap Agreement and the ISDA Interest Rate and Currency Exchange Agreement (together with the ISDA Interest Rate Swap Agreement, the **1987 ISDA Master Agreements**).

Memorandum therefore continues to reflect our understanding of the law of England and Wales as of today's date.

There are, however, three developments during the past year that we wish to highlight for ISDA members, even though they do not materially adversely affect our conclusions concerning the enforceability of the early termination and close-out netting provisions of the ISDA Master Agreements. The first two of these developments affect the cross-border insolvency of companies and therefore are potentially relevant to an ISDA member's dealing with an insolvent English or foreign corporate counterparty under an ISDA Master Agreement in the circumstances described in the Memorandum. These developments, however, do not apply to banks, so do not directly affect our analysis of the multibranch netting issues discussed in the Memorandum. The third development discussed below is the decision of Lightman J in *Commissioners for HM Revenue and Customs v Enron Europe Limited* (the **Enron Europe case**).²

1.1 Centre of Main Interests

The first development we wish to highlight is a case affecting the interpretation of the concept of "centre of main interests" under the Insolvency Regulation, which is discussed on page 16 of the Memorandum.

In the case of *Eurofood IFSC Ltd*,³ the European Court of Justice held that the presumption that a Company's centre of main interests is located in the place of its registered office can be rebutted only if factors that are both objective and ascertainable by third parties establish that its centre of main interests is located elsewhere. As a result, where a company carries on business in the Member State where its registered office is situated, the mere fact that its economic choices are or can be controlled by a parent company in another Member State will not be enough to rebut the registered office presumption.

The Insolvency Regulation does not apply to banks, and we are therefore of the view that this will not impact on the conclusions of our Memorandum. However, prior to the judgement delivered by the High Court in the case of *re BRAC Rent A Car International Inc*,⁴ it was considered that an administration order could not be made in relation to a foreign company. The High Court favoured a purposive interpretation of the Insolvency Regulation and considered that a company registered in the United States had its centre of main interests in England.

The decision in *Eurofood IFSC Ltd* will therefore provide more certainty for determining whether a Company's centre of main interests is located in England and, accordingly, whether an administration order can be made in respect of it.

1.2 The Cross-Border Insolvency Regulations

An important development in relation to cross-border insolvency is the UNCITRAL Model Law on Cross-Border Insolvency,⁵ which was implemented in England (and Scotland) on 4 April 2006 by the Cross-Border Insolvency Regulations 2006.⁶ The Cross-Border Insolvency Regulations do not apply to a Foreign Company that is a EEA bank (credit institution), or a non EEA-bank with an authorised branch in the UK, and so will not affect the conclusions set out in the Memorandum if the Foreign Company is such a credit institution.

² [2006] EWHC 824.

³ [2006] All ER (D) 20 (May).

⁴ [2003] 2 All ER 201.

⁵ The Model Law on cross-border insolvency as adopted by the United Nations Commission on International Trade Law (UNCITRAL) on 20 May 1997 (the **UNCITRAL Model Law**).

⁶ SI 2006/1030.

The Cross-Border Insolvency Regulations will, however, have an important effect on cross-border insolvency proceedings in England, as it enables a Foreign Company to obtain recognition of its local insolvency proceedings in England. Where foreign proceedings are recognised as foreign main proceedings, an automatic stay on specific creditor actions will occur. If foreign insolvency proceedings are recognised in England, the automatic stay does not, subject to discretionary relief being granted, affect the right of a creditor to exercise any right of set-off so long as that right would have been exercisable in a winding up in England.⁷

1.3 The *Enron Europe* case

In the *Enron Europe* case, the High Court reviewed a decision of the VAT Tribunal in relation to unpaid value-added tax (VAT) claimed by HM Revenue & Customs (**HMRC**) from Enron Europe Limited (as VAT representative for the Enron group) in relation to a series of physically-settled forward transactions in gas and electricity entered into between Enron Capital Trade & Resources Limited and Morgan Stanley Capital Group Inc. under a master netting agreement (the **Netting Agreement**). The Netting Agreement was not an ISDA Master Agreement, but apparently included default, early termination and close-out netting provisions bearing some similarity to those set out in the ISDA Master Agreements. We have not seen the full Netting Agreement at issue in the *Enron Europe* case, but the close-out netting provisions were set out in the judgment of Lightman J.

The issue in the case was the timing of the supplies of gas and electricity made under the forward transactions under the Netting Agreement, which under the applicable VAT rules was determined by the date on which the supplies were paid for. This, in turn, determined the accounting period for VAT in respect of those supplies, and therefore the accounting period in respect of which HMRC could make an assessment for VAT. During the course of his analysis of this issue, Lightman J considered and briefly described in his judgment the forms of contractual netting normally referred to as "close-out netting", "novation netting" and "settlement or payment netting". He concluded (in our view correctly) that the contractual netting arrangement set out in the Netting Agreement and set out in his judgment was an example of close-out netting rather than novation netting or settlement or payment netting.

Lightman J then went on to describe "close-out netting" generically as a form of contractual set-off arrangement without consideration of possible alternative characterisations of close-out netting, such as that on which we principally rely in our analysis of question 3 on pp 8-13 of the Memorandum, namely, the "flawed asset" analysis. Lightman J's generic description of "close-out netting" was, of course, *obiter dicta*. His analysis of the close-out netting provisions of the Netting Agreement for purposes of the issue before him was that it was a form of contractual set-off agreement, and this had certain consequences which were crucial to his ultimate decision in the *Enron Europe* case.

Without the opportunity to review the whole text of the Netting Agreement, it is not possible for us to be definitive, but it appears to us, based on the excerpted close-out netting provisions from the Netting Agreement, that an alternative characterisation of those provisions as a form of "flawed asset" arrangement would be arguable, but it is not clear whether such a characterisation was clearly formulated by counsel during the course of the arguments in that case or whether Lightman J took full account of such an alternative in his deliberation. In any event, there are certain important differences in the wording of the close-out netting provision in the *Enron Europe* case relative to the wording of the comparable provisions of Section 6 (including related definitions in Section 14) of the ISDA Master Agreements which we believe permit the analysis in the *Enron Europe* case to be distinguished from the analysis of the close-out netting provisions in the ISDA Master Agreement.

Also, there is nothing in Lightman J's judgment in the *Enron Europe* case that requires us to conclude that the only possible characterisation of a close-out netting agreement is on the basis that

⁷ Article 20(3) of the UNCITRAL Model Law as set out in Schedule 1 to the Cross-Border Insolvency Regulations 2006.

it effects a contractual set-off. As noted in his judgment, his decision in the case turned "on a careful analysis of the terms of the Netting Agreement". In other words, the correct characterisation is a matter of construction of the contract.

We have highlighted this case in this letter only because the judge considered close-out netting in some detail in a context similar to the context in which the ISDA Master Agreements are used, the transactions concerned being of a type falling within the definition of "Commodity Forward" in Appendix A to this letter. We believe that the *Enron Europe* case should be limited to its facts, at least with regard to its characterisation of the close-out netting provisions considered in that case. In any event, we note that the enforceability of close-out netting was not questioned in the case, but was instead assumed, the principal issue being the correct characterisation of close-out netting and the effect of that characterisation for purposes of determining the VAT timing issue in that case.

Finally, we note that in the Memorandum we considered and confirmed the enforceability of the close-out netting provisions of the ISDA Master Agreements on the basis of insolvency set-off. While the applicability of insolvency set-off was not an issue in the *Enron Europe* case, if the close-out netting provisions are enforceable on an insolvency set-off basis, then *a fortiori* those provisions are enforceable on a contractual set-off basis as a matter of English law for the reasons discussed in the Memorandum. Accordingly, in our view the decision of Lightman J in the *Enron Europe* case does not affect materially or adversely the conclusions set out in the Memorandum.

2. PENDING DEVELOPMENTS

We confirm that there are no pending legal or regulatory developments that are likely to affect materially and adversely the conclusions set out in the Memorandum.

3. ADDITIONAL OBSERVATIONS

Finally, we would like to make the following additional observations in relation to our analysis in the Memorandum under the heading "Enforceability of the ISDA Master Agreement under English Law" on pages 28-29 of the Memorandum:

- (a) In response to a query from an ISDA member, we thought it would be helpful to confirm that the analysis referred to above is intended to confirm the enforceability of the ISDA Master Agreement, including the early termination and close-out netting provisions, as a matter of general English law outside the context of an insolvency proceeding involving one or both of the parties. For this reason, we excluded assumption (g) in relation to this analysis, but we confirm that assumption (e) should also be considered as excluded for this purpose.
- (b) We would like to make conclusion (7) on page 29 of the Memorandum a bit more precise by deleting the word "The" at the beginning and inserting in its place the following words "A payment obligation under a Transaction governed by the".

This letter, which should be read together with the Memorandum, is addressed to ISDA solely for the benefit of its members in relation to their use of the ISDA Master Agreements. No other person may rely on this letter for any purpose without prior written consent. This letter may, however, be shown by an ISDA member to a competent regulatory authority for such ISDA member for the purposes of information only, on the basis that we assume no responsibility to such authority or to any other person as a result, or otherwise.

Yours faithfully,

A handwritten signature in grey ink that reads "Allen & Overy LLP". The signature is written in a cursive, flowing style.

Allen & Overy LLP

CERTAIN TRANSACTIONS UNDER THE ISDA MASTER AGREEMENTS

Basis Swap. A transaction in which one party pays periodic amounts of a given currency based on a floating rate and the other party pays periodic amounts of the same currency based on another floating rate, with both rates reset periodically; all calculations are based on a notional amount of the given currency.

Bond Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to purchase (in the case of a call) or sell (in the case of a put) a bond of an issuer, such as Kingdom of Sweden or Unilever N.V., at a specified strike price. The bond option can be settled by physical delivery of the bonds in exchange for the strike price or may be cash settled based on the difference between the market price of the bonds on the exercise date and the strike price.

Bullion Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to purchase (in the case of a call) or sell (in the case of a put) a specified number of Ounces of Bullion at a specified strike price. The option may be settled by physical delivery of Bullion in exchange for the strike price or may be cash settled based on the difference between the market price of Bullion on the exercise date and the strike price.

Bullion Swap. A transaction in which one party pays periodic amounts of a given currency based on a fixed price or a fixed rate and the other party pays periodic amounts of the same currency or a different currency calculated by reference to a Bullion reference price (for example, Gold-COMEX on the New York Commodity Exchange) or another method specified by the parties. Bullion swaps include cap, collar or floor transactions in respect of Bullion.

Bullion Trade. A transaction in which one party agrees to buy from or sell to the other party a specified number of Ounces of Bullion at a specified price for settlement either on a “spot” or two-day basis or on a specified future date. A Bullion Trade may be settled by physical delivery of Bullion in exchange for a specified price or may be cash settled based on the difference between the market price of Bullion on the settlement date and the specified price.

For purposes of Bullion Trades, Bullion Options and Bullion Swaps, “Bullion” means gold, silver, platinum or palladium and “Ounce” means, in the case of gold, a fine troy ounce, and in the case of silver, platinum and palladium, a troy ounce.

Buy/Sell-Back Transaction. A transaction in which one party purchases a security (in consideration for a cash payment) and agrees to sell back that security (or in some cases an equivalent security) to the other party (in consideration for the original cash payment plus a premium).

Cap Transaction. A transaction in which one party pays a single or periodic fixed amount and the other party pays periodic amounts of the same currency based on the excess, if any, of a specified floating rate (in the case of an interest rate cap), rate or index (in the case of an economic statistic cap) or commodity price (in the case of a commodity cap) in each case that is reset periodically over a specified per annum rate (in the case of an interest rate cap), rate or index (in the case of an economic statistic cap) or commodity price (in the case of a commodity cap).

Collar Transaction. A collar is a combination of a cap and a floor where one party is the floating rate, floating index or floating commodity price payer on the cap and the other party is the floating rate, floating index or floating commodity price payer on the floor.

Commodity Forward. A transaction in which one party agrees to purchase a specified quantity of a commodity at a future date at an agreed price and the other party agrees to pay a price for the same quantity

to be set on a specified date in the future. The payment calculation is based on the quantity of the commodity and is settled based, among other things, on the difference between the agreed forward price and the prevailing market price at the time of settlement.

Commodity Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to purchase (in the case of a call) or sell (in the case of a put) a specified quantity of a commodity at a specified strike price. The option can be settled either by physically delivering the quantity of the commodity in exchange for the strike price or by cash settling the option, in which case the seller of the option would pay to the buyer the difference between the market price of that quantity of the commodity on the exercise date and the strike price.

Commodity Swap. A transaction in which one party pays periodic amounts of a given currency based on a fixed price and the other party pays periodic amounts of the same currency based on the price of a commodity, such as natural gas or gold, or a futures contract on a commodity (e.g., Light Sweet Crude Oil on the New York Mercantile Exchange); all calculations are based on a notional quantity of the commodity.

Credit Protection Transaction.⁸ A transaction in which one party pays either a single fixed amount or periodic fixed amounts or floating amounts determined by reference to a specified notional amount, and the other party (the credit protection seller) pays either a fixed amount or an amount determined by reference to the value of one or more loans, debt securities or other financial instruments (each a "Reference Obligation") issued, guaranteed or otherwise entered into by a third party (the "Reference Entity") upon the occurrence of one or more specified credit events with respect to the Reference Entity (for example, bankruptcy or payment default). The amount payable by the credit protection seller is typically determined based upon the market value of one or more debt securities or other debt instruments issued, guaranteed or otherwise entered into by the Reference Entity. Credit protection transactions may also be physically settled by payment of a specified fixed amount by one party against delivery of specified Reference Obligations by the other party. A credit protection transaction may also refer to a "basket" (ten or less) or an "index" (eleven to one hundred twenty-five) of Reference Entities.

Credit Protection Transaction on Asset-Backed Securities. A Credit Protection Transaction for which the Reference Obligation is a cash or synthetic asset-backed security. Such a transaction may, but need not necessarily, include "pay as you go" settlements, meaning that the credit protection seller makes payments relating to interest shortfalls, principal shortfalls and write-downs arising on the Reference Obligation and the credit protection buyer makes additional fixed payments of reimbursements of such shortfalls or write-downs.

Credit Spread Transaction. A transaction involving either a forward or an option where the value of the transaction is calculated based on the credit spread implicit in the price of the underlying instrument.

Cross Currency Rate Swap. A transaction in which one party pays periodic amounts in one currency based on a specified fixed rate (or a floating rate that is reset periodically) and the other party pays periodic amounts in another currency based on a floating rate that is reset periodically. All calculations are determined on predetermined notional amounts of the two currencies; often such swaps will involve initial and or final exchanges of amounts corresponding to the notional amounts.

Currency Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to purchase (in the case of a call) or sell (in the case of a put) a specified amount of a given currency at a specified strike price.

Currency Swap. A transaction in which one party pays fixed periodic amounts of one currency and the other party pays fixed periodic amounts of another currency. Payments are calculated on a notional amount. Such swaps may involve initial and or final payments that correspond to the notional amount.

⁸ Some market participants may refer to credit protection transactions as credit swaps, credit default swaps or credit default options.

Economic Statistic Transaction. A transaction in which one party pays an amount or periodic amounts of a given currency by reference to interest rates or other factors and the other party pays or may pay an amount or periodic amounts of a currency based on a specified rate or index pertaining to statistical data on economic conditions.

Equity Forward. A transaction in which one party agrees to pay an agreed price for a specified quantity of shares of an issuer, a basket of shares of several issuers or an equity index at a future date and the other party agrees to pay a price for the same quantity of shares of an issuer to be set on a specified date in the future. The payment calculation is based on the number of shares and can be physically-settled (where delivery occurs in exchange for payment) or cash-settled (where settlement occurs based on the difference between the agreed forward price and the prevailing market price at the time of settlement).

Equity Index Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to receive a payment equal to the amount by which an equity index either exceeds (in the case of a call) or is less than (in the case of a put) a specified strike price.

Equity Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to purchase (in the case of a call) or sell (in the case of a put) shares of an issuer or a basket of shares of several issuers at a specified strike price. The share option may be settled by physical delivery of the shares in exchange for the strike price or may be cash settled based on the difference between the market price of the shares on the exercise date and the strike price.

Equity Swap. A transaction in which one party pays periodic amounts of a given currency based on a fixed price or a fixed rate and the other party pays periodic amounts of the same currency or a different currency based on the performance of a share of an issuer, a basket of shares of several issuers or an equity index, such as the Standard and Poor's 500 Index.

Emissions Allowance Transaction. A transaction in which one party agrees to buy or sell to the other party a specified quantity of emissions allowances at a specified price for settlement either on a "spot" basis or on a specified future date. An Emissions Allowance Transaction may be settled by physical delivery of emissions allowances in exchange for a specified price or may be cash settled based on the difference between the market price of Emissions Allowances on the settlement date and the specified price.

Floor Transaction. A transaction in which one party pays a single or periodic amount and the other party pays periodic amounts of the same currency based on the excess, if any, of a specified per annum rate (in the case of an interest rate floor), rate or index level (in the case of an economic statistic floor) or commodity price (in the case of a commodity floor) over a specified floating rate (in the case of an interest rate floor), rate or index level (in the case of an economic statistic floor) or commodity price (in the case of a commodity floor).

Foreign Exchange Transaction. A transaction providing for the purchase of one currency with another currency providing for settlement either on a "spot" or two-day basis or a specified future date.

Forward Rate Transaction. A transaction in which one party agrees to pay a fixed rate for a defined period and the other party agrees to pay a rate to be set on a specified date in the future. The payment calculation is based on a notional amount and is settled based, among other things, on the difference between the agreed forward rate and the prevailing market rate at the time of settlement.

Freight Transaction. A transaction in which one party pays an amount or periodic amounts of a given currency based on a fixed price and the other party pays an amount or periodic amounts of the same currency based on the price of chartering a ship to transport wet or dry freight from one port to another; all calculations are based either on a notional quantity of freight or, in the case of time charter transactions, on a notional number of days.

Interest Rate Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to receive a payment equal to the amount by which an interest rate either exceeds (in the case of a call option) or is less than (in the case of a put option) a specified strike rate.

Interest Rate Swap. A transaction in which one party pays periodic amounts of a given currency based on a specified fixed rate and the other party pays periodic amounts of the same currency based on a specified floating rate that is reset periodically, such as the London inter-bank offered rate; all calculations are based on a notional amount of the given currency.

Physical Commodity Transaction. A transaction which provides for the purchase of an amount of a commodity, such as coal, electricity or gas, at a fixed or floating price for actual delivery on one or more dates.

Repurchase Transaction. A transaction in which one party agrees to sell securities to the other party and such party has the right to repurchase those securities (or in some cases equivalent securities) from such other party at a future date.

Securities Lending Transaction. A transaction in which one party transfers securities to a party acting as the borrower in exchange for a payment or a series of payments from the borrower and the borrower's obligation to replace the securities at a defined date with identical securities.

Swap Option. A transaction in which one party grants to the other party the right (in consideration for a premium payment), but not the obligation, to enter into a swap with certain specified terms. In some cases the swap option may be settled with a cash payment equal to the market value of the underlying swap at the time of the exercise.

Total Return Swap. A transaction in which one party pays either a single amount or periodic amounts based on the total return on one or more loans, debt securities or other financial instruments (each a "Reference Obligation") issued, guaranteed or otherwise entered into by a third party (the "Reference Entity"), calculated by reference to interest, dividend and fee payments and any appreciation in the market value of each Reference Obligation, and the other party pays either a single amount or periodic amounts determined by reference to a specified notional amount and any depreciation in the market value of each Reference Obligation.

A total return swap may (but need not) provide for acceleration of its termination date upon the occurrence of one or more specified events with respect to a Reference Entity or a Reference Obligation with a termination payment made by one party to the other calculated by reference to the value of the Reference Obligation.

Weather Index Transaction. A transaction, structured in the form of a swap, cap, collar, floor, option or some combination thereof, between two parties in which the underlying value of the transaction is based on a rate or index pertaining to weather conditions, which may include measurements of heating, cooling, precipitation and wind.