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ISDA Publishes Close-Out Amount Protocol

On February 27, 2009, the International Swaps and Derivatives Association, Inc. ("ISDA") published the ISDA Close-out Amount Protocol ("Protocol") to enable parties to certain 1992 ISDA Master Agreements ("1992 ISDA Agreement") to amend the terms of those agreements on a multilateral basis to reflect the single measure of damages calculation upon early termination used in the ISDA 2002 Master Agreement ("2002 ISDA Agreement").

The insolvency of various Lehman Brothers trading entities in September 2008 and the ensuing market turmoil have highlighted the difficulty of obtaining Market Quotations as required under many 1992 ISDA Agreements during times of market stress. Even in instances where the required number of quotations could be obtained, in many cases those quotations were vastly divergent, making it difficult to determine if Market Quotation produced the requisite commercially reasonable result. Similar concerns following the market crises in 1998 and 1999 contributed to the development of the 2002 ISDA Agreement and the Close-out Amount payment measure included therein. Since its introduction, the 2002 ISDA Agreement has become increasingly common in the market place, although the 1992 ISDA Agreement continues to be widely used. In August 2008, effectively all major dealers in over-the-counter derivatives entered into a multilateral agreement with each other to amend outstanding 1992 ISDA Agreements among them to reflect the Close-out Amount methodology of the 2002 ISDA Agreement. ISDA recently reported to its members that market participants had asked ISDA to facilitate an amendment available to all market participants to replace the "Market Quotation" and "Loss" payment measures in the 1992 ISDA Agreements with the "Close-out Amount" standard of the 2002 ISDA Agreement. The Protocol responds to those requests.

Under the 1992 ISDA Agreement, parties generally select one of two payment measures to govern the calculation of any early termination payments: "Loss" and "Market Quotation." Loss requires a party to reasonably determine its losses and costs (or gains) in connection with the agreement or losses and costs incurred as a result of its terminating or reestablishing related hedge positions, based on internal models and/or, if desired, dealer quotations. Market Quotation requires a party to seek quotations from four leading dealers in the relevant market for the amount that would be payable upon entering into replacement transactions with the dealer that would preserve the economic equivalent of the transactions that are being terminated.

The "Close-out Amount" payment measure introduced in the 2002 ISDA Agreement combines elements from both the Market Quotation and Loss measures and essentially requires a good faith determination of the losses or gains that are or would be realized in providing for the economic equivalent of the material terms and option rights of the parties in respect of the terminated transactions. Close-out Amount strives to balance a greater degree of flexibility for the determining party in making its determinations with a recognized need for objectivity and transparency standards. The determining party thus must act in good faith and use commercially reasonable procedures to produce a commercially reasonable result. In doing so, the determining party may consider any relevant information including third-party quotations and relevant market data from dealers, end-users, information vendors and other sources, as well as information from internal models. This approach does not require that four quotations be

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obtained and an arithmetic average be determined. However, the determining party must take into consideration any third-party market quotations and relevant market data, unless it reasonably believes in good faith that such quotations or data are not readily available or would not produce a commercially reasonable result. In general, Close-out Amount provides more detailed and clearer guidance regarding the procedures and standards to be adhered to in conducting required early termination calculations. Such calculations increasingly have become more complex. If sufficiently large sums are at issue, those calculations face a heightened risk of challenge, especially in an insolvency of the defaulting party. If followed, more detailed guidelines may provide additional support to the party having to defend its determinations.

The Protocol has been developed by ISDA in cooperation with market participants as a tool to facilitate the adoption of the Close-out Amount methodology without the need for bilateral amendments of outstanding 1992 ISDA Agreements. By adhering to the Protocol, each adhering party agrees to amend the terms of any 1992 ISDA Agreement that has been entered into (either executed in full by the parties or deemed entered into in connection with a long-form confirmation between the parties) prior to the date on which the later of the two adhering counterparties adheres to the Protocol. The Protocol does not cover any 1992 ISDA Agreements where only one of the counterparties adheres to the Protocol or that are entered into after the date on which both parties have adhered to the Protocol. The Protocol also will not affect any 1992 ISDA Agreement that involves any third-party credit support document that expressly requires the consent of the credit support provider for amendments or modifications of such 1992 ISDA Agreement. In addition, an adhering party must represent that adherence in itself will not adversely affect any obligations owed under any credit support document.

Every 1992 ISDA Agreement covered by the Protocol, as well as related credit support documents and ISDA definition booklets, will be amended to replace the Market Quotation or Loss methodology with the Close-out Amount concept. However, adhering parties are given the option to preserve Loss to the extent applicable to all or certain transactions under their 1992 ISDA Agreements and to avoid amending the various ISDA definition booklets by making respective elections in the Adherence Letter. The Protocol also will not affect any bespoke valuation mechanic agreed to between the parties in the Schedule to, or in a confirmation of a transaction under, their 1992 ISDA Agreement.

Parties who choose to adhere to the Protocol must complete and execute an Adherence Letter and submit scanned original and conformed copies of the letter by e-mail to ISDA. A copy of the text of the Protocol and a copy of the Adherence Letter are available on ISDA's website at www.isda.org. The Protocol opened for adherence on February 27, 2009. Currently, no cutoff date exists for adherence. ISDA may impose a cutoff at any time upon 30 days notice but has stated that there are no current plans to do so.

Once adhered to the Protocol, parties have limited ability to revoke their adherence. Adhering parties may submit a Revocation Letter to ISDA annually during October. Revocation by an adhering party will be effective as of December 31 of the same year and only with respect to existing counterparties that have not yet adhered to the Protocol.

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This memorandum does not purport to and should not be considered to address all relevant issues under the Protocol. It is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on the content of this memorandum. For further information and questions regarding the issues discussed in this memorandum, please contact Manuel S. Frey at (212) 373-3127 or Jordan E. Yarett at (212) 373-3126.