company it has invested in. Luxembourg has a comprehensive and expanding network of double tax treaties covering, in particular, all major European and American trading partners.

Typically, the SICAR will invest only in transferable securities, and the income it earns thereon will not bear corporate income tax in Luxembourg as a consequence of the exemption described earlier.

Dividends and capital gains earned by foreign investors will likewise bear no Luxembourg tax. Dividend distributions by a SICAR are exempt from the 20 per cent dividend withholding tax. Capital gains realised by non-resident investors upon sale of their shares in a SICAR are not taxable in Luxembourg.

Transparent SICAR

If the SICAR is incorporated as a *société en commandite simple* (SCS), that is a private partnership, then it will be completely disregarded for tax purposes. The SCS is by nature a see-through entity, which means that the income earned by a SCS is deemed earned instantly by its shareholders in proportion to their respective stakes in the SCS.

Investors are deemed to have directly earned the income realised on the investments in the target companies. All income earned by the SCS will only be taxed in the hands of each investor and according to the rules of his country of residence. The legislator has carefully reviewed the tax regime of the SCS to ensure that non-resident investors will under no circumstances be subject to any Luxembourg tax as a consequence of their stake in a SICAR SCS.

Being totally disregarded, the SCS is not considered a resident of Luxembourg for tax purposes. It does not benefit from tax treaties concluded by Luxembourg. On the other hand, investors in the SICAR should in most cases be able to avail themselves directly of any tax treaties between their country of residence and the country of each target company from which they are deemed to have received income.

Good Law—Serious Implications: *Enron Australia v TXU Electricity*

*Gary Walker and Guy Usher**

Overview

The recent decision of the New South Wales Supreme Court in *Enron Australia v TXU Electricity*[1] is being hailed by derivatives lawyers as further evidence, if any were needed, of the robustness of key provisions of the 1992 ISDA Master Agreement in the face of counterparty insolvency.

As natural a response as that may be, and however correct the decision from a legal perspective, the *commercial* result is irreconcilable with certain fundamental principles relating to regulatory capital netting and fair value accounting. At the same time, it rekindles credit and systemic risk concerns understandably considered by many to have been extinguished for good.

Industry-level consultation between ISDA and relevant regulatory and accounting authorities (including the FSA and the IASB) is necessary in order to address the incongruities to which the facts of the case give rise.

Enron v TXU: the facts

Enron Australia (Enron) and TXU Electricity (TXU) were party to a large number of electricity swaps governed by a 1992 ISDA Master Agreement ("the Master"). For early termination purposes, "Market Quotation" and "Second Method" were stated to apply while "Automatic Early Termination" was disapplied.

In late 2001/early 2002, at a time when the swaps were net in-the-money to Enron/net out-the-money to TXU, Enron was placed first into administration and then into liquidation. Each occurrence was an event of default under the Master. Although contractually so entitled, TXU chose not to designate an early termination date pursuant to s.6(a) of the Master, since that would have had the effect of crystallising its contingent liability—the net out-the-money amount—under the swaps. At the same time, relying on the standard "no default as a condition to payment" provision set out in s.2(a)(iii) of the Master, it ceased making payments to Enron.

Enron's liquidator sought leave of the court to have the swaps disclaimed in such a way as to compel TXU concurrently to designate an early termination date.

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1. [2003] N.S.W.S.C. 1169.

The court declined, refusing to rewrite the Master so as to deprive TXU of its contractual entitlement (i) to choose whether and when to designate an early termination date and (ii) not to pay while Enron remained in default.

From TXU's perspective, the decision was welcome. From Enron's, it was anything but. Not only was it insolvent and therefore unable to realise value in the swaps by continuing to perform its side of the bargain; it had no means, either, to bring about designation of an early termination date that was a contractual prerequisite to that value being immediately crystallised in its favour.

Position under English Law

A critical question is whether the outcome would have been any different under English law. We suggest that it would not. It is to be remembered that Enron's liquidator did not seek a simple disclaimer of the swap contracts. Indeed, a simple disclaimer would have been of no use whatsoever, since it would have amounted to a foregoing of the value inherent in the transactions.

Instead, the liquidator sought a *qualified* disclaimer that encompassed an *acceleration* of the transactions—one that, if successful, would have enabled it to "get at" the net in-the-money amount. It did this on the basis of an Australian law insolvency provision conferring discretion upon the court, in relation to applications for a disclaimer, to make "such orders in connection with matters arising under, or relating to, the contract as the court considers just and equitable". For a variety of reasons that are beyond the scope of this article, the court decided that that discretion, although wide, did *not* give it power to rewrite the Master in the manner requested by the liquidator.

The question, therefore, is whether any comparable (or wider) provision exists under English insolvency law that would enable a liquidator of an English registered company, in analogous circumstances, to make or succeed in a similar application. There is no need to delve too deeply into the textbooks. The short answer is that there is not. The same case would either not be brought before an English court or, if brought, would fail for similar reasons as those given by the court in *Enron v TXU*. The outcome, therefore, would be identical.

Moral Hazard—A New Low

Moral hazard is ever-present in today's financial markets. One need only consider the position of a bank holder of credit default protection on a distressed reference entity—to which the bank is at the same time a relationship lender—to see that this is so.

At the macro level, *Enron v TXU* compounds the dilemma. For if such a credit protection holder is concurrently net out-the-money to the reference entity under a series of ISDA-governed derivative transactions to which Automatic Early Termination is stated not to apply, it has more incentive than ever to leave the reference entity to its fate (rather than accommodate it in restructuring), call in its credit protection and "walk away" from its net obligations under the derivatives.

There is a disquieting consequence at the micro level too. By electing Second Method, Enron and TXU had expressly agreed that *on designation of an early termination date*, neither would walk away from its obligations, irrespective of whichever was out-the-money and whichever was in default at the relevant time. It seems unprincipled, therefore, that TXU should be able subsequently to disregard that agreement, on the technical ground that an early termination date had *not* been designated, when TXU itself was the sole arbiter of the decision to designate and had a great deal to gain from *not* exercising its discretion. TXU's inaction is a classic example, in fact, of moral hazard in operation!

Credit/Systemic Risk—A New High

Creditors, back-to-back counterparties and shareholders in/to any entity that undertakes significant derivative activity ought to be deeply troubled by *Enron v TXU*. For it illustrates that, even if Second Method is elected, net in-the-money amounts attributable to such an entity (*qua* defaulting party) may nevertheless not be realisable.

If the defaulting entity is sizeable, the systemic implications are equally significant. Indeed, it is precisely a policy desire to mitigate systemic risk of this nature that predisposes, for example, the Financial Services Authority (FSA) in its approach to walkaway provisions in netting agreements entered into by and between regulated entities. It is to this—perhaps the most disturbing—aspect of *Enron v TXU* that we now turn.

What Now for Regulatory Capital Netting?

The minimum contractual features that the FSA considers a close-out netting agreement (such as the 1992 ISDA Master Agreement) should possess in order for it to be recognised for supervisory (including netting for capital adequacy) purposes are set out in s.6 of Chapter NE (Collateral and Netting) of *The Interim Prudential Sourcebook for Banks*. Parallel regulatory requirements—all of which have their genesis in the Basle Capital Accord—exist in many other jurisdictions. Section 6.4 of Chapter NE deals with walkaway clauses and provides as follows:

> The netting agreement should not contain a *walkaway clause*.
>
> A *walkaway clause* is a provision which permits a non-defaulting counterparty to make limited payments, or no payments at all, to the estate of the defaulter, even if the defaulter is a net creditor.

> In other words, the walkaway clause *would have the effect of taking away or limiting the right to receive payment, which a party which is a net creditor would otherwise have, by virtue of the fact that such party is a defaulting party.*[2]

As we have intimated, the policy reason behind the FSA's diktat in relation to walkaway clauses is a desire to limit risk in the financial sector—the systemic implications of large numbers of non-defaulting parties walking away from net out-the-money positions to an insolvent counterparty being obvious. The "reward" for regulatory compliance in this regard is that, subject to meeting various other criteria, regulated entities are permitted to allocate capital in respect of mastered derivative exposures on a net, as opposed to gross, basis.

It is instructive to consider the effect of regulatory attrition in this regard. Whereas the 1987 ISDA Interest Rate and Currency Exchange Agreement embeds a walkaway provision as standard,[3] the 1992 ISDA Master Agreement allows parties to make a positive election one way or the other.[4] The 2002 ISDA Master Agreement does away with First Method as a concept altogether.

The key point is that the debate has hitherto centred exclusively on s.6(e). *Enron v TXU*, on the other hand, moves the goalposts and brings into sharp and unpalatable focus the fact that ss.2(a)(iii) and 6(a) (ISDA Master "ever-presents", whatever the vintage) are capable, when working in tandem, of behaving in similar "walkaway" fashion. In effect, they reintroduce First Method "via the back door". If that is the right conclusion—and looking at the final paragraph of s.6.4 of Chapter NE as set out above, we think it must be—then netting for capital adequacy purposes is catastrophically undermined pending at the very least (i) a change to ISDA (and similarly drafted master netting) documentation and (ii) related clarification from the FSA.

It is worth pointing out that the particular "chicken" that is *Enron v TXU* is bound to "come home to roost" very quickly. The reason for this is that regulated entities that seek to net under Chapter NE are required, by s.6.1 of the same, to obtain *reasoned independent legal opinions* that confirm, among other things, the absence of walkaway provisions from their netting agreements. It is a further requirement that those same opinions are updated annually and that their validity is confirmed by the relevant entity to the FSA. Since no law firm will be able to give an opinion that is not materially (and adversely) qualified as a result of *Enron v TXU*, reporting entities and the FSA will be forced to act. Opinion providers, reporting entities and regulators in many other jurisdictions will be confronted by a similar conundrum.

2. Emphasis added.
3. See s.6(e)(i)(1).
4. Compare First Method with Second Method under s.6(e)(i)(1)–(4).

Back to the Future with IAS 39

IAS 39, in particular those of its provisions dealing with fair value and hedge accounting, runs into similar difficulties. For what is the point in marking derivatives to market (or recognising their effectiveness as hedging instruments) if, on an insolvency of the reporting entity, any positive value is either non-realisable or does not wash through in cash-flow terms? As *Enron v TXU* demonstrates, accounting for derivatives in either of these ways will, in certain circumstances, be entirely unreflective of the contractual and commercial realities.

There is a further consequence in so far as the facts of the case are relevant only to insolvent counterparties that are net *in-the-money*. Insolvent counterparties that are net *out-the-money* can expect the liability to be crystallised and to be subject to a creditor's proof. The result is that net in-the-money amounts ought perhaps to be reported at zero while net out-the-money amounts continue to be reported at fair value—a seemingly odd result.

If contractual integrity in the context of IAS 39 has never been high on the ASB's/IASB's agenda, *Enron v TXU* more than suggests that it now should be.

Repo Agreements

A comparison of analogous provisions within non-ISDA industry master netting agreements is also instructive. Take the 2000 Version of the TBMA/ISMA Global Master Repurchase Agreement (GMRA) as an example. Its para.6(j) incorporates conditionality language analogous to ISDA's s.2(a)(iii) and its para.10(a) confers upon a non-defaulting party similar discretion, in relation to the designation of an early repurchase date, to that on which TXU relied *vis-à-vis* Enron under s.6(a).

There, however, the two agreements part company. Under the 2000 GMRA, the conditionality language is an elective, whereas under ISDA it is embedded. Conversely, Automatic Early Termination under ISDA is an elective, whereas it is embedded (in relation to winding-up and liquidation petitions) under the 2000 GMRA. Critically, in any event, repo transactions are by their nature self-collateralising, so there is little or nothing to be gained by a non-defaulting party in *not* terminating (and setting off against the cash or security side, as the case may be, of the repo) once its counterparty has defaulted.

In short, 2000 GMRAs are unlikely to be beset by the same problems that many ISDA agreements now face.

Some Good News?

If anything good comes out of *Enron v TXU*, it is the support that it lends to the enforceability of flawed asset provisions on insolvency. It is to be remembered that First Method (or its s.2(a)(iii)/s.6(a) "in tandem

equivalent") is an example of a flawed asset provision in so far as it subjects the contingent rights of an in-the-money party to the condition (or "flaw") that such rights are only enforceable if the in-the-money party is not itself in default. In this regard, *Enron v TXU* not only upholds the principle of flawed asset provisions generally but also illustrates that the "flaw" attaching to a flawed asset cannot be disclaimed unless the asset to which it is attached is also disclaimed. Those venerating ISDA documentation for this reason alone in the aftermath of *Enron v TXU* would, however, do well to consider some of the wider issues to which the decision has given rise.

Solutions and Next Steps

There are some obvious solutions to the difficulties presented by *Enron v TXU*. Electing for Automatic Early Termination would have "saved" Enron in relation to its insolvency (although not in relation to most other events of default[5]). Equally, had Enron held sufficient collateral, particularly if under an ISDA CSA, TXU may well have been persuaded to make the required designation, close out the relevant transactions and set off.

Perhaps the most simple and compelling solution, however, would have been a pre-trading amendment to s.6(a) of the Master that had the effect of *obliging* TXU (*qua* non-defaulting party) to designate an early termination date within x days of the occurrence of Enron's insolvency. Certainly, the latter suggestion has been made in more than one quarter subsequent to the decision; and the fact that it runs counter to conventional bias against defaulting counterparties does not diminish its practical value in circumstances such as those that arose in *Enron v TXU*.

Any solution will, however, require industry examination and consensus—consensus that ought readily to be forthcoming given the imperatives discussed in this article. Notably, the FSA has already formally requested the Bank of England's Financial Markets Law Committee to consider the issues and the latter's conclusions are awaited.

5. See s.6(a) of the 1992 ISDA Master Agreement.