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Commodity Supply Agreements are Swap Agreements: A Counterintuitive but Quite Real Safe Harbour from Preference Avoidance

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I. Introduction

'Your commodity supply agreement with the debtor is a swap agreement and therefore the transfers you received cannot be avoided.' Your client may wonder at your premise as it delights in your conclusion. Sections 546(e) and (g) of the Bankruptcy Code exempt from avoidance transfers from the debtor that would otherwise be subject to preference or constructive fraudulent transfer liability.¹ The exemption is based upon the relationship of such transfers to the markets for financial derivatives. The text of sections 546(e) and (g) and the Bankruptcy Code's definitions of key terms like 'forward contract merchant', 'forward contract', 'forward contract agreement', and 'swap agreement' together constitute expansive exemptions from avoidance liability. This article examines how payments made under ordinary commodity supply agreements can fit readily within these statutory exemptions.

Section 546(e) exempts any transfer made by or to (or for the benefit of) a forward contract merchant in connection with a forward contract. Much of the scanty case law was decided under the section 546(e) exemption.

Section 546(g) exempts, among other things, transfers made by or to (or for the benefit of) a 'swap participant'. Under section 101(53B), a 'commodity forward agreement' is a 'swap agreement'. Under section 101(53C) a party to a 'swap agreement' is a 'swap participant'. Under section 546(g), a transfer to or from or for the benefit of a 'swap participant' is exempted

from avoidance. No proof is required, under section 546(g), that either party to the transfer has been a forward contract merchant. As discussed below, it would appear that any transfer pursuant to a 'forward contract' or forward agreement that has a commodity as its subject matter qualifies for exemption from avoidance as a preference or a constructively fraudulent transfer. The legislative history of the relevant statutory changes and the construction of such statutes by the courts tend to validate the broad reach indicated by the language of the statute.²

As discussed in detail below, the exemptions under consideration are among those provisions of the Bankruptcy Code that are intended to protect financial markets from systemic risk, in particular risks to markets in derivatives from the insolvency and bankruptcy of a party to derivative contracts. Financial derivatives are agreements that derive their value from the value of some underlying assets, which are often but not always commodities.³ Such agreements have themselves become assets traded with increasing velocity and at increasing aggregate values over the last 30 years (at least until the crash of 2008), often on an unsecured basis, both on exchanges and over the counter (among private parties).⁴ The 2008 crash in certain derivatives markets and the massive governmental responses thereto embody anxieties over systemic risk from interruptions in market flows of such transactions. Because most over the counter derivatives transactions are unsecured, the fear is of potentially catastrophic transferred failures from one firm to another.⁵

Notes

- 1 Throughout this article, 'Bankruptcy Code' means title 11 of the United States Code.
- 2 In Edward Morrison and Joerg Riegel, 'Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankruptcy Debtors and Bankruptcy Judges,' 13 *Am. Bankr. Inst. L. Rev.* 641, 652 n. 78 (2005), the authors conclude that Congress was fully aware that the new definition of 'swap agreement' would cover all forwards, quoting the following legislative history: 'The use of the term 'forward' in the definition of 'swap agreement' is not intended to refer only to transactions that fall within the definition of 'forward contract'. Instead, a 'forward' transaction could be a 'swap agreement' even if not a 'forward contract'.' 652 n. 78, quoting H.R. REP. NO. 109-31 at 129 (2005).
- 3 Christopher J. Redd, 'Treatment of Securities and Derivative Transaction in Bankruptcy, Part I,' 7 *Am. Bankr. Inst. J.* 36 (2005).
- 4 In 1990, over the counter derivatives consisted primarily of commodity forwards and interest rate and currency swaps; from 1990 to 2004, the notional value of interest rate swaps increased from USD 1 trillion to USD 183 trillion. Redd (2005) at 37.
- 5 See Eleanor Heard Gilbane, 'Testing the Bankruptcy Code Safe Harbors in the Current Financial Crises,' 18 *Am. Bankr. Inst. L. Rev.* 241, 242-46 (2010); Jonathon Keath Hance, 'Derivatives at Bankruptcy: Lifesaving Knowledge for the Small Firm,' 65 *Wash & Lee L. Rev.* 711, 739 (2008);

Such anxiety influenced amendments to the Bankruptcy Code that have expanded the scope of financial instruments and parties thereto covered under the so-called 'safe harbour provisions',⁶ of which sections 546(e) and (g) form a small subset.⁷ For example, in 1990 Congress broadened the scope of liquidation and termination rights for forward contracts and swap agreements.⁸ After the Long Term Capital Management debacle in 1998 quickened fears of systemic risks in derivatives markets,⁹ the President's Working Group on Financial Markets called for legislative changes designed to provide legal certainty for derivatives in order to reduce systemic risk and remove impediments to innovation.¹⁰

The 2005 and 2006 amendments to the Bankruptcy Code changed both section 546(e), by extending the exemption to the transfers described in the second paragraph above, and section 546(g), by enlarging the definition of 'swap agreement'. These expansions of the avoidance exemptions of sections 546(e) and (g) were done for the announced purpose of eliminating uncertainty as to the range of transactions and parties covered.¹¹ Commentators Edward Morrison and Joerg Riegel characterised these amendments as follows:

'The expansion is particularly striking for derivatives contracts such as forwards, futures, swaps, and options. Prior to 2005, the Code's protections were broad for swaps (any counterparty received protection) and narrow for other derivatives contracts (only some counterparties were protected). The Act obliterates this asymmetry, principally by defining swap to include, effectively, all derivatives contracts.'

In so doing, the Code has moved from protecting particular parties to protecting entire markets.¹²

The discussion below describes how the definitions of covered transactions and covered participants very likely cover many transfers made in payment for commodities delivered pursuant to supply agreements, even though such contracts are not themselves traded on financial contract exchanges.

Many companies use derivatives to hedge risk. According to a survey conducted in 2009 by the International Swaps and Derivatives Association, over 94% of the world's largest 500 companies use derivatives to manage and hedge risk, and 50.9% of them use derivatives to manage commodity prices.¹³ The use of derivatives has rebounded to levels pre-dating the 2008-2009 financial crisis.¹⁴ A simple means of managing price risk is to have one's commodity supply contracts provide for future delivery of a commodity at a set price. These familiar features of supply contracts may suffice to bring transfers made thereunder within the ambit of the exemptions in section 546(e) and (g).

In a leading case construing section 546(e), *BCP Liquidating LLC v. Bridgeline Gas Marketing, LLC (In re Borden Chemicals and Plastics Operating Ltd. P'ship)*, 336 B.R. 214 (Bankr. D. Del. 2006), the court described hedging as insuring against price changes.¹⁵ Upon its review of statutory text and legislative history, the court concluded that in enacting and amending section 546(e), Congress intended to exempt transactions that are risk-shifting in nature, including risks that that the price of a commodity (natural gas in that case) would rise or fall after a contract is executed.¹⁶ The breadth of the section 546(e) exemption implied

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and Thomas G. Kelch and Howard J. Weg, 'Forward Contracts, Bankruptcy Safe Harbors and the Electricity Industry,' 51 *Wayne L.R.* 49, 63-64 (2005). In Stephen J. Lubben, 'The Bankruptcy Code Without Safe Harbors,' 84 *Am. Bankr. L.J.* 123, 129-32 (2010), the author argues that the Bankruptcy Code's safe harbours do not reduce systemic risks.

6 For accounts of the amendments process and legislative history relating thereto, see Hance (2008) at 738-61; Kelch and Weg (2005) at 62-63 and 102-05; Shmuel Vassar, 'Derivatives in Bankruptcy,' 60 *Bus. Law.* 1507, 1510 (2005) (analysing the public policy rationales underlying the safe harbour provisions); and Morrison and Riegel (2005) at 642-52; see also *Hutson v E.I Du Pont de Nemours & Co.*, (In re *National Gas Distribs., LLC*), 556 F.3d 247, 252-54 (4th Cir. 2009) (in general and quoting with approval Morrison and Riegel (2005) at 642); and *BCP Liquidating LLC v Bridgeline Gas Marketing, LLC (In re Borden Chemicals and Plastics Operating Ltd. P'ship)*, 336 B.R. 214, 219-20 (Bankr. D. Del. 2006). For recital of the public laws amending sections 546(e) and (g), and effective dates thereof, see 5-546 Collier on Bankruptcy §§ 546.LH [2][a][5] and [6] (2009).

7 See 11 U.S.C. §§ 362(b) 6-7, 17 & 27, and 362 (o) (exemptions from the automatic stay to set-off, close out, and terminate positions); see also §§ 555, 556, 559, 560, and 561 (exemptions from automatic stay and bar to enforcement of *ipso facto* clauses).

8 Hance (2008) at 746.

9 See Rhett G. Campbell, 'Financial Markets Contracts and BAPCPA,' 79 *Am. Bankr. L.J.* 697, 698-701 (2005) and Hance (2008) at 748-52. The crisis was resolved by certain large market participants providing USD 3.6 billion to take over 90% of the existing portfolio plus operational control. The bailout then regarded as monumental would hardly register among the governmental market interventions in 2008 and 2009.

10 Hance (2008) at 716.

11 Hance (2008) at 753-54. See also Morrison and Riegel at 642.

12 Morrison Riegel (2005) at 642.

13 'ISDA Research Notes – Spring 2009,' at <www.isda.org/researchnotes/pdf/ISDA-Research-Notes2.pdf> (visited 12 Dec. 2010).

14 Jacob Bunge, 'Derivatives Exchanges Flourish,' *Wall St. J.*, 5 Jan. 2011 at C26 (reporting that overall futures trading volume at the Chicago Mercantile Exchange fell 20% from 2008 to 2009 and rose 19% from 2009 to 2010, with an average of 12.2 million derivative contracts changing hands each day; commodities futures trading rose 23% from 2009 to 2010).

15 *BCP Liquidating LLC v Bridgeline Gas Marketing, LLC (In re Borden Chemicals and Plastics Operating Ltd. P'ship)*, 336 B.R. at 220-22.

16 *Id.* at 221.

by the court's construction accords with the view that Congress expanded safe harbours to promote the stability of worldwide financial markets at the expense of preserving value to creditors as a group from avoidance actions in bankruptcy cases.¹⁷

This article addresses first the section 546(e) exemption, and then related concepts of 'forward contract merchant', 'forward contract', and 'commodity'. It then turns to the section 546(g) exemption, which eases a defendant's burden by dispensing with the need to prove the existence of a 'forward contract merchant' or a 'settlement payment', and which requires proof only that the transfer was made pursuant to a 'commodity supply agreement'.

II. Section 546(e): Exemptions for transfer (or settlement payment) to a forward contract merchant on a forward contract

Section 546(e) was added to the Bankruptcy Code in 1982, as described by the Tenth Circuit Court of Appeals in a passage recently quoted by the Sixth Circuit:

'In 1982, Congress was concerned about the volatile nature of the commodities and securities markets, so former section 764(c) was replaced by sections 546(e) and 741(5) and (8) "to clarify and, in some instances, broaden the commodities market protections and expressly extend similar protections to the securities market." H.R. Rep. No. 420, 97th Cong., 2d Sess. 2 (1982), *reprinted in* 1982 U.S. Code Cong. & Admin. News 583, 583. ... Again, Congress's purpose was "to minimize the displacement caused in the commodities and securities markets in the event of a major bankruptcy affecting those industries." *Id.* at 1, *reprinted in* 1982 U.S. Cong. & Admin News at 583.¹⁸

Current section 546(e) provides that:

'(e) Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not

avoid a transfer that is a ... settlement payment, as defined in section 101 or 741 of this title, made by or to (or for the benefit of) a ... forward contract merchant, ... or that is a transfer made by or to (or for the benefit of) a ... forward contract merchant ... in connection with a ... forward contract, that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.¹⁹

Thus, if an avoidance action defendant can establish that one party to the transaction was a 'forward contract merchant' and either that (x) the transfer was a 'settlement payment', or (y) the agreement in connection with which the transfer was made was a 'forward contract', *then* the transfers received by the defendant cannot be avoided as preferential or constructively fraudulent.²⁰ Put otherwise, if a forward contract merchant is involved, but the underlying contract is not a forward contract, it suffices if the transfer itself is a 'settlement payment'. Alternatively, where the underlying contract is a forward contract, then the transfer need not qualify as a settlement payment. The defendant is armed with multiple proof options, once it gets over the 'forward contract merchant' hurdle.

A. 'Forward contract merchant' and 'commodity'

The scope of the definition of 'forward contract merchant' depends upon the scope of the definition of 'commodity'. Section 101(26) of the Bankruptcy Code defines 'forward contract merchant' as, among other things, 'an entity the business of which consists in whole or in part of entering into forward contracts as or with merchants in a commodity (as defined in section 761) or any similar good, article, service, right, or interest which is presently or in the future becomes the subject of dealing in the forward contract trade'.²¹

Section 761(8) of the Bankruptcy Code provides that 'commodity' has the meaning assigned to it in the Commodity Exchange Act,²² where 'commodity' is defined as '[various agricultural products] and all other goods and articles, ... and all services, rights, and interests

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17 Campbell (2005) at 712.

18 *Quality Stores, Inc. v Alford (In re QSI Holdings, Inc.)*, 571 F.3d 545, 548-49 (6th Cir. 2009) (quoting *Kaiser Steel Corp. v Charles Schwab & Co., Inc.*, 913 F.2d 846, 849 (10th Cir. 1990)) (footnote and quotation omitted).

19 11 U.S.C. § 546(e) (2009). Under section 546(e) and (g), the exemption to a trustee's avoidance powers expressly does not apply to avoidance, pursuant to section 548(a)(1)(A) of the Bankruptcy Code, of transfers made or obligations incurred with the *actual* intent to hinder, delay, or defraud creditors. The court got this exactly wrong in *Hutson v United States of America, Dept. of the Army (In re National Gas Distributors, LLC)*, 415 B.R. 209, 213-24 (Bankr. E.D.N.C. 2009) ('The swap defense is a complete defense to the trustee's avoidance claims under both § 548(a)(1)(A) and § 548(a)(1)(B).'). It should further be noted that *all* fraudulent transfer avoidance pursuant to section 544(b) appears to be barred where section 546(e) and (g) exemptions apply. Hence, the trustee cannot take advantage of the usually longer limitations periods provided under state fraudulent transfer laws for avoidance of actually fraudulent transfers.

20 The 'transfer made by or to (or for the benefit of) a ... forward contract merchant ... in connection with a ... forward contract' formulation was added to section 546(e) as a result of amendments made by the Financial Netting Improvements Act of 2006, Pub. L. No. 109-390, § 5(b)(1) (2006).

21 11 U.S.C. § 101(26) (2009).

22 11 U.S.C. § 761(8) (2009).

in which contracts for future delivery are presently or in the future dealt in'. 7 U.S.C. § 1a(4) (2009).²³ The Commodity Exchange Act's definition of 'commodity' is intended to be very broad,²⁴ extending to all goods and articles (except onions) and services and interests 'in which contracts for future delivery are presently or in the future dealt in'. In parsing the language of the definition of 'commodity', one is led to conclude that any physical thing or service or interest is deemed to have been a 'commodity' for its entire existence if it is *of a kind that* is or at some point becomes the subject of contracts for future delivery that are or could be bought and sold.²⁵

Thus, *any* agreement for the purchase of, for example, electricity, becomes an agreement for the purchase of a commodity.²⁶ Likewise, since polypropylene, for example, has become the subject of such contracts (traded on commodities derivatives exchanges), *any* agreement for the purchase of polypropylene (including any agreements that predate the appearance of such contracts on trading exchanges) becomes an agreement for the purchase of a commodity.

So, what is not a commodity? Referring to an influential Canadian case dealing with Canadian bankruptcy 'safe harbour' provisions, one commentator suggested that a commodity has two principal features: (1) commodities are fungible, and (2) commodities have considerable volatility in price.²⁷ The Commodity Exchange Act definition would add the element 'in which contracts for future delivery are presently or in the future dealt in'. It would appear that finished goods like automobiles or televisions (and complex manufactured components thereof) would not qualify as fungible or as subject to considerable volatility in price. Further, unless contracts for the future delivery of automobiles or televisions become traded on exchanges, these goods or articles (or complex component parts thereof) would not appear to qualify as commodities under the Commodity Exchange Act definition.

B. Forward contract merchants as entities in the business as or with merchants in a commodity

To reiterate, section 101(26) of the Bankruptcy Code defines 'forward contract merchant' as, among other things, 'an entity the business of which consists in whole or in part of entering into forward contracts as or with merchants in a [commodity, etc.]'²⁸ What is required to show that a business 'in whole or in part' enters into forward contracts, and what is required to show that an entity is a 'merchant'?

The definition provides that an entity qualifies as a 'forward contract merchant' if its business consists 'in whole or in part' of entering into such forward contracts. No critical proportion is required on the face of the definition. Would the incidence of a few such transactions (or even *one*?) suffice to qualify an entity as a 'forward contract merchant'?²⁹ One may plausibly argue that an entity whose principal business is manufacturing or providing services unrelated to 'the forward contract trade' would nevertheless qualify as a 'forward contract merchant' if such entity entered into a few forward contracts 'as or with merchants in a commodity or any similar service right, or interest which is presently or in the future becomes the subject of dealing in the forward contract trade'. As noted in the introduction to this article, a significant percentage of large companies use derivatives to manage price risks. Possibly a typical manufacturer's business would, in the ordinary course, satisfy the 'in whole or in part' element of the section 101(26) definition.

What constitutes a 'merchant' in this context? In a case involving the sale of natural gas (and, therefore, no issue as to whether the good involved is a 'commodity'), the Bankruptcy Court for the Northern District of Texas held that a merchant 'is one that is not acting as an end-user or a producer', but rather must be one that buys, sells, or trades in a market.³⁰ The court rejected the argument that any person in connection with its business that enters into a forward contract falls within

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- 23 7 U.S.C. § 1a(4) (2009). The Futures Trading Practices Act of 1992, PL. 102-546, went into effect on 28 October 1992. The definition of 'commodity' has not been changed since.
- 24 Kelch and Weg (2005) at 66-67.
- 25 The definitional breadth of 'commodity' is abetted by the Bankruptcy Code's definitions of 'forward contract merchant' and of 'forward contract' (as set forth below), where the clause 'which is presently or in the future becomes the subject of dealing in the forward contract trade' modifies 'commodity (as defined in section 761) or any similar good, article, service, right, or interest.' See 11 U.S.C. §§ 101(25) and 101(26) (emphasis added); see *Mirant Americas Energy Marketing, LP v Kern Oil & Refining Co. (In re Mirant Corporation)*, 319 B.R. 548, 566 (Bankr. N.D. Tex. 2004) (following *Williams v Morgan Stanley Capital Group, Inc. (In re Olympic Natural Gas Co.)*, 294 F.3d 737, 741 (5th Cir. 2002)).
- 26 Several courts have so found as regards electricity. See *Lightfoot v MXEnergy Electric, Inc. (In re MBS Management Services, Inc.)*, 2010 Bankr. LEXIS 2135 (Bankr. E.D. La. June 29, 2010) at *5, n. 5 (collecting cases).
- 27 Kelch and Weg (2005) at 66 n. 98 (citing *In re Blue Range Resource*, 192 D.L.R. (4th) 281 (ABCA 2000)), Kelch and Weg also state that the Chicago Board of Trade's definition of 'commodity' in its Glossary of Futures and Options Terminology is 'an article of commerce or a product that can be used for commerce'. Kelch and Weg (2005) at 66 (citation omitted).
- 28 11 U.S.C. § 101(26) (2009).
- 29 See *Mirant Americas Energy Marketing, LP v Kern Oil & Refining Co. (In re Mirant Corporation)*, 319 B.R. 548, 567-70 (Bankr. N.D. Tex. 2004) (appears to require more).
- 30 *Id.* at 567; but see Kelch and Weg (2005) at 81 (criticising the court's conclusion as summary and unreasoned).

the scope of section 101(26), stating that such argument ignores the ‘merchant’ term of the definition and would lead to the absurd result of ‘the virtual absorption of the executory contract rules found in section 365 of the Code by the exception carved out to protect the forward contract market ...’.³¹ In a different case involving the sale of natural gas, the Bankruptcy Court for the District of Delaware appears to hold that an entity should be both ‘a buyer and a seller’ of the commodity in order to qualify as a ‘merchant’ for ‘forward contract merchant’ purposes.³²

Thus, it is conceivable that a challenge to a section 546(e) defence could be mounted upon a narrow construction of loosely-worded features (‘in whole or in part’, ‘merchant’) of the definition of a ‘forward contract merchant’. However, in the discussion of section 546(g) below, we shall see that the ability to rebut the existence of a ‘forward contract merchant’ may not serve the trustee, for a defendant’s proof that the transfers were made pursuant to a commodity forward agreement suffices by itself to establish a section 546(g) defence to avoidance.

C. Forward contract merchants and forward contracts

It is important to recognise that the section 546(e) exemption does not require that the ‘forward contracts’ *themselves* be dealt in or subject to being dealt in the forward contract trade. Section 101(25) of the Bankruptcy Code, in relevant part, defines ‘forward contract’ as:

‘(A) a contract (other than a commodity contract, as defined in section 761) for the purchase, sale, or transfer of a commodity, as defined in section 761(8)

of this title, or any similar good, article, service, right, or interest which is presently or in the future becomes the subject of dealing in the forward contract trade, or product or byproduct thereof, with a maturity date more than two days after the date the contract is entered into, including, but not limited to, a repurchase or reverse repurchase transaction (whether or not such repurchase or reverse repurchase transaction is a “repurchase agreement,” as defined in this section)[,] consignment, lease, swap, hedge transaction, deposit, loan, option, allocated transaction, unallocated transaction, or any other similar agreement[.]’³³

Similarly to the Bankruptcy Code’s definition of ‘forward contract merchant’, this definition of ‘forward contract’ specifies that the subject matter of such contracts must be a ‘commodity ... or any similar good, article, service, right or interest which is presently or in the future becomes the subject of dealing in the forward contract trade.’ To this subject matter specification, the definition of ‘forward contract’ adds two other qualities: (i) the forward contract must have a maturity date of more than two days after the date the contract is entered into and (ii) the forward contract must not be a ‘commodity contract’ as defined in section 761 of the Bankruptcy Code. Maturity dates designate a due date for commencement of performance.³⁴ Supply contracts often have maturity dates (essentially, due dates of delivery of the commodity) of more than two days after the contract is entered into.

In cases involving natural gas supply contracts, the Fourth and Fifth Circuit Courts of Appeals agreed that the exclusion of ‘commodity contract’ as defined in section 761³⁵ from the definition of ‘forward contract’ is intended to indicate that, unlike futures contracts,

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31 *Mirant* at 568-69.

32 *BCP Liquidating LLC*, 336 B.R. at 225.

33 11 USC 101(25) (2009). The rest of the definition, added in 2005, expands its scope:

- (B) any combination of agreements or transactions referred to in subparagraphs (A) and (C);
- (C) any option to enter into an agreement or transaction referred to in subparagraph (A) or (B);
- (D) a master agreement that provides for an agreement or transaction referred to in subparagraph (A), (B), or (C), together with all supplements to any such master agreement, without regard to whether such master agreement provides for an agreement or transaction that is not a forward contract under this paragraph, except that such master agreement shall be considered to be a forward contract under this paragraph only with respect to each agreement or transaction under such master agreement that is referred to in subparagraph (A), (B), or (C); or
- (E) any security agreement or arrangement, or other credit enhancement related to any agreement or transaction referred to in subparagraph (A), (B), (C), or (D), including any guarantee or reimbursement obligation by or to a forward contract merchant or financial participant in connection with any agreement or transaction referred to in any such subparagraph, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with section 562.

34 See *Kelch and Weg* (2005) at 67-68 (discussing *Mirant Americas Energy Marketing, LP*, 319 B.R. 548, 565-66).

35 Section 761(4) provides that ‘commodity contract’ means:

- (A) with respect to a futures commission merchant, contract for the purchase or sale of a commodity for future delivery on, or subject to the rules of, a contract market or board of trade;
- (B) with respect to a foreign futures commission merchant, foreign future;
- (C) with respect to a leverage transaction merchant, leverage transaction;
- (D) with respect to a clearing organization, contract for the purchase or sale of a commodity for future delivery on, or subject to the rules of, a contract market or board of trade that is cleared by such clearing organization, or commodity option traded on, or subject to the rules of, a contract market or board of trade that is cleared by such clearing organization;

forward contracts need *not* traded on exchanges, can be settled by physical delivery of the commodity, may be directly negotiated between the parties, and may be non-assignable.³⁶ After reaching those conclusions upon review of the statutory language, the Fifth Circuit Court of Appeals drew on legislative history to reject the argument that section 546(e) was intended only to prevent disruptions within the securities markets themselves, and that sales transactions between private parties outside of exchanges therefore should not be exempt from avoidance:

‘The legislative history of § 546(e) indicates that the provision was intended “to minimize the displacement caused in the commodities and securities market in the event [of] a major bankruptcy affecting those industries.” H.R. REP. NO. 97-420, at 1 (1982), *reprinted in* 1982 U.S.C.C.A.N. 583. More specifically, Congress sought to prevent the ‘ripple effect’ created by ‘the insolvency of one commodity or security firm from spreading to other firms and possibly threatening the collapse of the affected Industry’. *Id.* By including references to both the commodities and the securities markets, it seems clear that Congress meant to exclude from the stay and avoidance provisions both on-market, and the corresponding off-market, transactions.’³⁷

The Fifth Circuit’s quotation of legislative history suggests a limiting principle to the exemption of payments under a ‘forward contract’ from avoidance under section 546(e): such a contract must be made in

connection with a party involved in a ‘major bankruptcy’ and would be capable of producing ‘ripple effects’. However, the statutory language does not express any such principle. Further, application of such a limitation on a case-by-case basis would vitiate any Congressional interest in fostering predictability in the application of safe harbor provisions in the Bankruptcy Code.

D. Settlement payments

Under section 546(e), a transfer is exempt from avoidance where it is a ‘settlement payment’ made by or to (or for the benefit of) a ‘forward contract merchant’. The ‘settlement payment’ element does not present a formidable obstacle for avoidance defendants. Section 101(51A) of the Bankruptcy Code broadly defines ‘settlement payment’ as ‘a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, a net settlement payment, or any other similar payment commonly used in the forward contract trade’.³⁸

The Fifth Circuit Court of Appeals has held that the term ‘settlement payment’, in the context of section 546(e), should be interpreted very broadly with regard to the forward contract trade.³⁹ In *BCP Liquidating LLC*, the Bankruptcy Court for the District of Delaware reviewed the statutory language, noted that the New York Mercantile Exchange’s definition of ‘forward contract’ specifies that ‘payment in full is due at the time of,

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(E) with respect to a commodity options dealer, commodity option;

(F) any other agreement or transaction that is similar to an agreement or transaction referred to in this paragraph;

(G) any combination of the agreements or transactions referred to in this paragraph;

(H) any option to enter into an agreement or transaction referred to in this paragraph;

(I) a master agreement that provides for an agreement or transaction referred to in subparagraph (A), (B), (C), (D), (E), (F), (G), or (H), together with all supplements to such master agreement, without regard to whether the master agreement provides for an agreement or transaction that is not a commodity contract under this paragraph, except that the master agreement shall be considered to be a commodity contract under this paragraph only with respect to each agreement or transaction under the master agreement that is referred to in subparagraph (A), (B), (C), (D), (E), (F), (G), or (H); or

(J) any security agreement or arrangement or other credit enhancement related to any agreement or transaction referred to in this paragraph, including any guarantee or reimbursement obligation by or to a commodity broker or financial participant in connection with any agreement or transaction referred to in this paragraph, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with section 562[.]

11 U.S.C. § 761(4)(2009).

36 See *Hutson v E.I Du Pont de Nemours & Co.*, (*In re National Gas Distribs., LLC*), 556 F.3d 247, 255-57 (4th Cir. 2009); *Williams v Morgan Stanley Capital Group, Inc.* (*In re Olympic Natural Gas Co.*), 294 F.3d 737, 741-42 (5th Cir. 2002). See also *BCP Liquidating LLC v Bridgeline Gas Marketing, LLC* (*In re Borden Chemicals and Plastics Operating Ltd. P’ship*), 336 B.R. 214 (2006) (agreeing with *Williams*).

37 *Williams v Morgan Stanley*, 294 F.3d at 742 n5.

38 11 U.S.C. § 101(51A) (2009) (emphasis added).

39 *Williams v Morgan Stanley Group* (*In re Olympic Natural Gas Co.*), 294 F.3d 737, 742 (5th Cir. 2002) (collecting cases); and *BCP Liquidating LLC v Bridgeline Gas Mktg., LLC* (*In re Borden Chems. & Plastics Operating Ltd. P’ship*), 336 B.R. 214, 225 (Bankr. D. Del. 2006) (applying broad construction of ‘settlement payment’ in the context of transfers made following delivery of natural gas). Regarding interpretations of the very similar definition of ‘settlement payment’ applicable to the securities trade, *Collier on Bankruptcy* observes that there has been ‘significant disagreement among courts about whether the section 546(e) defense is limited to transfers made in connection with the public securities market or whether the statute also encompasses transfers related to nonpublic transactions’, *Collier on Bankruptcy* § 546.06[2][b][i] and n. 35a (2009). The Sixth Circuit Court of Appeals has resolved the issue in favour of the latter and broader conception. *Quality Stores, Inc. v Alford* (*In re QSI Holdings, Inc.*), 571 F.3d 545, 550 (6th Cir. 2009) (‘settlement payments’ are not limited to payments involving publicly held securities).

or following, delivery’, and concluded that a payment made ten days after invoice constituted a ‘settlement payment’ within the meaning of section 546(e).⁴⁰ For that Court, it would appear that any non-advance payment under a forward contract qualifies as a ‘settlement payment’.

E. Transfers to a forward contract merchant in connection with a forward contract

Under changes made to section 546(e) in 2006, which went into effect too late to apply to the *BCP Liquidating LLC* case, there is no longer any need for an avoidance action defendant to jump through the accommodating ‘settlement payment’ hoop. Under current 546(e), a transfer is insulated from avoidance where it ‘is a transfer made by or to (or for the benefit of) a ... forward contract merchant ... in connection with a ... forward contract[.]’⁴¹

Why is there no case law construing this seemingly easier way of exempting transfers from avoidance liability? Perhaps the expansions to the safe harbour exceptions have overleaped themselves. As explained immediately below, in 2005, the Bankruptcy Code was amended to enlarge effectively the scope of section 546(g), by insulating all parties to a ‘commodity forward agreement’ from avoidance liability. The exemption provided by section 546(g) now accommodates all transfers made in connection with a forward contract whether or not a ‘forward contract merchant’ is involved. Now a defendant who received a transfer pursuant to a commodity supply agreement that qualifies as a ‘commodity forward agreement’ need prove neither that the transfer was a ‘settlement payment’ nor that a ‘forward contract merchant’ was involved.

III. Section 546(g): Exemptions for ‘swap participants’

Section 546(g), which was added to the Bankruptcy Code in 1990,⁴² exempts ‘swap participants’ from avoidance actions. Section 546(g) currently provides that, ‘[n]otwithstanding sections 544, 545, 547, 548(a)(1) (B) and 548(b) of this title, the trustee may not avoid a transfer, made by or to (or for the benefit of) a swap

participant ... under or in connection with any swap agreement and that is made before the commencement of the case, except under section 548(a)(1)(A) of this title’.⁴³ A business lawyer may intuit a categorical distinction between a ‘swap participant’ – protected by section 546(g) from avoidance – and a supply agreement counterparty. However, the definitions of ‘swap participant’ and ‘swap agreement’ in the Bankruptcy Code join together what nature keeps asunder.

Section 101(53C) of the Bankruptcy Code defines ‘swap participant’ as an entity that, ‘at any time before the filing of the petition, has an outstanding swap agreement with the debtor’.⁴⁴ The definition of ‘swap agreement’ at section 101(53B) of the Bankruptcy Code is long and capacious. In relevant part – relevant, that is, for commodity supply agreements aspiring to be deemed swap agreements – the section provides that ‘swap agreement’ means:

‘(i) any agreement, including the terms and conditions incorporated by reference in such agreement, which is –

...

(II) a spot, same day-tomorrow, tomorrow-next, forward, or other foreign exchange, precious metals, or other commodity agreement;

...

(VII) a commodity index or a commodity swap, option, future, or forward agreement;

(ii) any agreement or transaction that is similar to any other agreement or transaction referred to in this paragraph and that –

(I) is of a type that has been, is presently, or in the future becomes, the subject of recurrent dealings in the swap or other derivatives markets (including terms and conditions incorporated by reference therein); and

(II) is a forward, swap ... or spot transaction on one or more rates, currencies, commodities, equity securities, or other equity instruments, debt securities or other debt instruments, quantitative measures associated with an occurrence, extent of an occurrence, or contingency associated with a financial, commercial, or economic consequence, or economic or financial indices or measures of economic or financial risk or value;

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40 *BCP Liquidating LLC*, 336 B.R. at 225-26.

41 11 U.S.C. § 546(e) (2009). The ‘in connection with a forward contract’ phrase was added as a result of amendments made by the Financial Netting Improvements Act of 2006, Pub. L. No. 109-390, § 5(b)(1) (2006). The *In re Borden Chemicals and Plastics Operating Ltd. P’ship* chapter 11 case, within which the *BCP Liquidating LLC* adversary proceeding was filed, was commenced prior to the effective date of the 2006 amendment, and so the defendant there did not have that aspect of current section 546(e) available to it.

42 See 5-546 Colliers on Bankruptcy § 5-546.LH [2][a][6] (2009).

43 11 U.S.C. § 546(g) (2009).

44 11 U.S.C. § 101(53C) (2009).

(iii) any combination of agreements or transactions referred to in this subparagraph;

(iv) any option to enter into an agreement or transaction referred to in this subparagraph;

(v) a master agreement that provides for an agreement or transaction referred to in clause (i), (ii), (iii), or (iv), together with all supplements to any such master agreement, and without regard to whether the master agreement contains an agreement or transaction that is not a swap agreement under this paragraph, except that the master agreement shall be considered to be a swap agreement under this paragraph only with respect to each agreement or transaction under the master agreement that is referred to in clause (i), (ii), (iii), or (iv) ...⁴⁵

According to section 101(53B)(i)(VII), a ‘commodity forward agreement’ is a ‘swap agreement’, whereupon it follows that its counterparties are ‘swap participants’. Since section 546(g) exempts from avoidance any transfers ‘made by or to (or for the benefit of) a swap participant under or in connection with any swap agreement’, a defense to avoidance would be made by the proof that the agreement from which payment arose is a ‘commodity forward agreement’.

Yes, that is it. Receiving transfers pursuant to a ‘commodity forward agreement’ insulates a transferee from avoidance of the transfers as preferential or constructively fraudulent. Any ‘forward contract’ that has a commodity as its subject matter qualifies.⁴⁶ Unlike section 546(e), section 546(g) does not require a defendant to prove that one or another counterparty is a ‘forward contract merchant’.

This conclusion is supported by a comparison of subsection (i) of section 101(53B) with subsection (ii). Subsection (ii) of the section 101(53B) definition of ‘swap agreement’ adds references to ‘recurrent dealings in the swap or other derivatives markets’, and thus underscores the absence of such a required quality among the instruments – like ‘commodity forward agreement’ – comprised under subsection (i) of the

definition. Section 101(53B)(ii) includes within the scope of ‘swap agreement’ agreements or transactions ‘similar to’ those referred to in the definition, where such agreement or transaction is both:

‘(I) of a type that has been, is presently, or in the future becomes, the subject of recurrent dealings in the swap or other derivatives markets (including terms and conditions incorporated by reference therein); and

(II) is a forward, swap, future, option, or spot transaction on one or more rates, currencies, commodities, equity securities, or other equity instruments, debt securities or other debt instruments, quantitative measures associated with an occurrence, extent of an occurrence, or contingency associated with a financial, commercial, or economic consequence, or economic or financial indices or measures of economic or financial risk or value.’⁴⁷

To restate: the absence in subsection (i) of the explicit relationships to financial markets required in subsection (ii) strongly implies that there is no need to tie ‘swap agreements’ as defined in subsection (i) to financial markets. Indeed, it appears that any old ‘commodity forward agreement’ will do.⁴⁸

The term ‘commodity forward agreement’ was added to the definition of ‘swap agreement’ in 2005, and is not defined in the Bankruptcy Code. In *Hutson v. E.I. Du Pont de Nemours & Co.*, (*In re National Gas Distribs., LLC*), 556 F.3d 247 (4th Cir. 2009), the Court found that a natural gas supply agreement could qualify as a ‘swap agreement’ on the grounds of being a ‘commodity forward agreement’ even though such agreement was individually negotiated, physically settled, and not traded on any exchange or in an market.⁴⁹ Key to its reasoning was the Court’s view that ‘commodity forward agreement’ must be broader than ‘forward contract’ (as defined at section 101(25)) and since (agreeing with the Fifth Circuit and the Bankruptcy Court of the District of Delaware) the latter need not

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45 11 U.S.C. § 101(53B). According to Campbell, “[s]wap agreement” means everything it did before BAPCPA plus much more. The definition is still nothing more than a long listing of trade terms for various kinds of swap agreements with no attempt at a functional definition[.] ... It also includes any combination of such agreements or transactions, any option to enter into them, a master agreement that provides for such agreement or transaction ... [and the] term “or any similar agreement” is ubiquitous throughout the definitions [of ‘swap agreement’ and related terms].’ Campbell (2005) at 703-04.

46 Morrison and Riegel conclude that ‘Congress was fully aware that the new definition of “swap agreement” would cover all forwards, quoting the following legislative history: “The use of the term ‘forward’ in the definition of ‘swap agreement’ is not intended to refer only to transactions that fall within the definition of ‘forward contract.’ Instead, a ‘forward’ transaction could be a ‘swap agreement’ even if not a ‘forward contract.’” Morrison and Riegel (2005) at 652 n. 78 (quoting H.R. REP. NO. 109-31 at 129 (2005)).

47 11 U.S.C. § 101(53B)(ii) (2009).

48 Section 101(53B)(i)(II), on its face, would appear to include among ‘swap agreements’ any commodity agreement at all, including non-forward agreements such as spot agreements. At the least, the Reform Act ‘plainly expands the scope of protected transactions – swaps, forwards, commodity contracts, repos, and securities contracts – but it does so in a way that renders the concept of ‘protected parties’ meaningless in the context of derivatives contracts. The new definition of ‘swap’ is so broad that a counterparty to any derivative contract – including any counterparty to a forward or commodity contract – will find a safe harbor under the Code.’ Morrison and Riegel (2005) at 664.

49 *Hutson v. E.I. Du Pont de Nemours & Co.*, (*In re National Gas Distribs., LLC*), 556 F.3d 247, 255-57 (4th Cir. 2009).

be traded in a market or on an exchange, therefore the same must be true of the former.⁵⁰

The natural gas supply agreement at issue in *Hutson* was not documented as a 'swap agreement' or as a 'commodity forward agreement', yet the Court deemed it to be a swap.⁵¹ As an initial matter, and consistent with the Fifth Circuit's holding in *Williams v. Morgan Stanley Capital Group, Inc. (In re Olympic Natural Gas Co.)*, 294 F.3d 737, 741-42 (5th Cir. 2002), the Court reversed the Bankruptcy Court's ruling that the natural gas supply agreements constituted simple unprotected supply contracts because they involved the physical delivery of natural gas.⁵²

The Court distinguished the gas supply contracts from 'simple supply contracts' in two ways. First, the Court concluded that the contracts contained financial hedging elements by which the customers hedged their risk of future fluctuations in the price of natural gas.⁵³ The 'real hedging elements' present were summarised as follows by the Court: '[t]he contracts obliged the customers to buy, and National Gas to sell, gas on a future date at a price fixed at the time of contracting, regardless of fluctuations in the market price'.⁵⁴

Second, the Court distinguished the gas supply contracts by reasoning that they could influence and create risk for broader markets and their participants, and that it was this sort of systemic risk that Congress intended to address with the Reform Act amendments.⁵⁵ The Court illustrated the market influence as follows: 'A business can enter into a forward agreement with a party who then, in reliance on that forward agreement, enters into another contract with yet another market participant, who in turn may enter into even other contracts. And so a simple agreement may readily become tied to the broader markets that Congress aimed to protect in BAPCPA'.⁵⁶ The distinctions offered by the Court appear to apply to any supply agreement where the subject matter of the agreement is a commodity (hence the possibility that other parties in a web

of reliance may influence the market) and where the elements of a 'forward contract' are met.

The Court remanded the case to the trial court for a determination of whether the contracts at issue are commodity forward agreements (and, therefore, 'swap agreements'). To guide the trial court, the Court provided certain non-exclusive elements that a 'commodity forward agreement' should have: the subject matter must be a 'commodity' (in that the expected costs of performance must be attributable to the expected cost of the underlying commodity, determined at the time of contracting) and price, quantity, and time elements must be fixed at the time of contracting for delivery more than two days later.⁵⁷

The Fourth Circuit thus suggested modest restraints to the Bankruptcy Code's statutory equation of commodity supply agreements with swap agreements. In *Hutson v. M.J. Soffe Co. (In re National Gas Distributors, LLC)*, 412 B.R. 758 (Bankr. E.D.N.C. 2009), the bankruptcy court to which the Fourth Circuit directed its guidance stated that the Fourth Circuit provided 'firm guidelines for this court to follow' and 'enumerated requirements'.⁵⁸ The court found that the natural gas supply contracts at issue did not provide for a fixed quantity of natural gas, and therefore did not qualify as commodity forward agreements, and therefore the court granted summary judgment to the trustee (denying the safe harbour exemption from avoidance) on that issue.⁵⁹

However, the Fourth Circuit's suggestions or enumerated requirements have not definitively interpreted the safe harbour of section 546(g). In *Lightfoot v. MX-Energy Electric, Inc. (In re MBS Management Services, Inc.)*, 2010 Bankr. LEXIS 2135 (Bankr. E.D. La. June 29, 2010), the bankruptcy court declined to apply to an alleged 'forward contract' (under section 546(e)) the Fourth Circuit's seeming requirement that a commodity forward agreement set the quantity to be supplied.⁶⁰ The court noted correctly that no such requirement is present in the Bankruptcy Code.⁶¹

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50 *Id.* at 255-56.

51 Congressional awareness of the capaciousness of the definition of 'swap agreement' is belied by the following language from a House report: '[The new "swap agreement" definition] should not be interpreted to permit parties to document non-swaps as swap transactions. Traditional commercial arrangements such as supply agreements, or other non-financial market transactions, such as commercial, residential, or consumer loans, cannot be treated as "swaps" under ... the Bankruptcy Code simply because the parties purport to document or label the transactions as swap agreements.'

Morrison and Riegel (2005) at 657 n. 106 (quoting H.R. REP. NO. 109-31 at 129 (2005)).

52 *Hutson* at 258. The Court noted that many courts have held that 'forward contracts' may be settled by physical delivery of the underlying commodity. *Id.*

53 *Id.*

54 *Id.*

55 *Id.* at 257.

56 *Id.*

57 *Id.* at 259-60.

58 *Hutson v. M.J. Soffe Co. (In re National Gas Distributors, LLC)*, 412 B.R. 758, 762-63 (Bankr. E.D.N.C. 2009).

59 *Id.* at 767.

60 *Lightfoot v. MXEnergy Electric, Inc. (In re MBS Management Services, Inc.)*, 2010 Bankr. LEXIS 2135 (Bankr. E.D. La. June 29, 2010) at *14-15.

61 *Id.* at *7.

The disagreement between the Fourth Circuit and the *Lightfoot* court reminds us that whether your client's commodity supply agreement is a swap agreement, such that payments received thereunder are insulated from preference liability, remains a matter of judicial interpretation. In its favour, though, in refusing the Fourth Circuit's gloss, the *Lightfoot* court applies the broad language Congress enacted. That language invites the counterintuitive equation of commodity supply agreements with swap agreements for the purpose of defending against avoidance of transfers.

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